

Diploma in International Taxation

Paper – 2

International Tax - Practice (Part-I)



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword to the Eighth Edition

As the global business landscape continues to evolve, and cross border transactions are on the rise, the significance of understanding international tax principles for a tax practitioner has become more crucial than ever. The Direct Taxes Committee (DTC) of the Institute of Chartered Accountants of India (ICAI) has always been mindful of developments in the areas of international taxation and has been consistently endeavouring to augment the knowledge of professionals through live webinars, conferences, seminars, diploma and certificate courses. The Diploma in International Taxation launched by the ICAI through DTC among other means of dissemination of knowledge also equip the members with the latest information on international taxation and make them aware of the challenges of the international taxation domain.

The Background Material for Diploma in International Taxation has been designed to provide a comprehensive overview of the key concepts, regulations, and practices that shape the field of international taxation. Whether one is a seasoned tax professional seeking to broaden expertise or a beginner entering this complex domain for the first time, this useful resource aims to be a companion in unravelling the complexities of international taxation frameworks for all.

The background material offers an in-depth exploration of essential topics, ranging from the basics of international tax law to the intricacies of transfer pricing, tax treaties, and the resolution of international tax disputes which would enable a reader to develop a well-rounded understanding of the subject matter.

I am happy to note that the DTC has developed this eighth edition of Background Material for Diploma in International Taxation to help the members to keep them abreast with the latest developments, legislative changes and emerging trends in the ever-evolving world of taxation.

I congratulate CA. Sanjay Kumar Agarwal, Chairman, CA. Piyush S. Chhajed, Vice-Chairman and all other members of Direct Taxes Committee of ICAI for responsibly undertaking this strenuous task within a short span of time.

I am sure that the members will be benefitted from the diploma course & the material will provide valuable addition to their knowledge.

17.01.2024
New Delhi

CA. Aniket Sunil Talati
President, ICAI

Preface to the Eighth Edition

In the era of globalization, understanding the intricacies of international taxation is crucial for professionals working in tax advisory, consultancy, and compliance roles. As businesses expand globally, tax considerations become increasingly intricate, necessitating a deep comprehension of international tax laws, treaties, and practices.

This comprehensive background material has been curated to provide members with a solid foundation in the complex and dynamic field of international taxation. This is intended to serve as a guide for members pursuing the Diploma in International Taxation, offering a structured and detailed overview of key concepts, principles, and frameworks. The curriculum is meticulously crafted to address the multifaceted nature of international taxation, covering both theoretical foundations and practical applications.

The background material delves into the fundamental aspects of international taxation, providing a comprehensive overview of the principles that govern international tax structures, impact of domestic tax systems, transfer pricing, double taxation treaties, and more. It also provides the practical insights and approach which will enhance the practical understanding of the subject matter, preparing students for the challenges they may encounter in their professional endeavours. The background material adopts a global perspective, acknowledging the diversity of tax systems and regulations. This allows students to develop a nuanced understanding of the challenges and opportunities in the international tax landscape. Effort has been to keep the background material updated by incorporating the latest regulations, Indian and foreign judicial pronouncements, as well as publications, reports, and guidelines by international organisations, such as the Organisation for Economic Cooperation and Development, United Nations and G-20 group.

We are grateful to CA. Aniket Sunil Talati, President, ICAI and CA. Ranjeet Kumar Agarwal, Vice-President, ICAI for being the guiding force behind the revision of this Background Material. We would like to place on record our appreciation and sincere thanks to the Members of the Direct Taxes Committee, Co-opted members and Special invitees who, despite their busy schedule, contributed in updating the background material. We would, also, like to acknowledge the contribution by Sri S. P. Singh, Ex-IRS, who has meticulously reviewed all chapters.

Last but not the least, we also acknowledge the efforts made by CA. Mukta Kathuria Verma, Secretary, Direct Taxes Committee, and her team member CA. Vikas Kumar Gupta, Deputy Secretary for their technical and administrative assistance in bringing out this background material well in time.

The Diploma in International Taxation is a stepping stone towards expertise in a field that plays a pivotal role in the global economy. We hope this resource proves valuable in the member's quest for knowledge and proficiency in international taxation. Best wishes for a successful and enriching learning experience.

CA. Sanjay K. Agarwal
Chairman,
Direct Taxes Committee, ICAI

CA. Piyush S Chhajer
Vice-Chairman,
Direct Taxes Committee, ICAI

Place: New Delhi

Date: 17.01.2024

Acknowledgement

The Direct Taxes Committee (DTC) of ICAI acknowledges the contribution made by the Committee Members, Co-opted Members, Special Invitees and experts, in revising the “*Background Material for Diploma in International Taxation*”. DTC of ICAI places on record its gratitude for their contribution in enrichment of knowledge of the members.

Committee Members:(2023-24)

Council Members: CA. Sanjay Kumar Agarwal, Chairman; CA. Piyush S Chhajed, Vice-Chairman; CA. Chandrashekhar Vasant Chitale; CA. Dheeraj Kumar Khandelwal; CA. Purushottamlal Khandelwal; CA. Mangesh Pandurang Kinare; CA. Sridhar Muppala; CA. Prasanna Kumar D; CA. Rajendra Kumar P; CA. Cotha S Srinivas; CA. Sushil Kumar Goyal; CA.(Dr.) Debashis Mitra; CA. Rohit Ruwatia; CA. (Dr.) Anuj Goyal; CA. Gyan Chandra Misra; CA. Prakash Sharma; CA. Kemisha Soni; CA. (Dr.) Raj Chawla; CA. Hans Raj Chugh; CA. Pramod Jain; CA. Charanjot Singh Nanda; Shri Ritvik Ranjanam Pandey; Shri Sanjay Kumar

Co-opted Members: CA. Mahendra Kumar Modi; CA. Aseem Chawla; CA. Sriram Ranganathan; CA. Manish Bansal; CA. Sushil Pransukhka; CA. Rajiv Sahni; CA. N. C. Hegde; CA. Sudhir Kumar Agarwal

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Contributors:

CA . Arvind Tuli; CA. Naman Shrimal; CA. Kriti Chawla; CA. Vivek Jain; CA. Akshat Maheshwari; CA. Karan Sukhramani; CA. Noopur Agashe; CA. Manoj Kumar; CA. Parul Jolly, CA. Neha Gupta; CA. Sushil Agarwal

Foreword to the Seventh Edition

The Committee on International Taxation is one of the important non-standing Committees of the Institute of Chartered Accountants of India (ICAI). As a partner in nation building, ICAI through this Committee submits Pre and Post-budget Memoranda pertaining to International Taxation. Apart from the same, the Committee at regular intervals examines the tax laws, rules, circulars, notifications etc. relating to international taxation issued by the CBDT and sends suitable suggestions for improvements. The Committee also submits inputs/submissions to OECD from time to time. Besides conducting various activities ICAI through this Committee regularly organises Workshops/Seminars/ Conferences/ Refresher Courses/ Residential course, prepares e-learning modules, revises its existing publication, releases new publication and many more.

One of the core activities of the Committee is to organise *Post Qualification Diploma in International Taxation*. I am happy to mention that the Committee has prepared the seventh edition of Background Material for Diploma in International Taxation in which all the amendments made upto Finance Act, 2022, have been incorporated. It has been written and reviewed by eminent experts in the area of taxation. This course, if completed, would provide an aspiring practitioner the desired confidence to practice in this complex and upcoming field.

For this course, an open book, case study-based assessment pattern for international taxation Assessment Test (INTT-AT) has been adopted recently to initiate practical understanding of the subject. As there are only few chartered accountants who are practicing in this area, there are plentiful of professional opportunities available for the person who masters in this area.

I appreciate the efforts of CA. Sanjay Kumar Agarwal, Chairman, CA. Cotha S. Srinivas, Vice-Chairman and other members of the Committee on International Taxation for updating this publication and for conducting the course in a professional manner.

I am sure that this seventh revised edition of the Background Material for Diploma in International Taxation will be very useful to the members.

Date: 25.01.2023

Place: New Delhi

CA. (Dr.) Debashis Mitra

President, ICAI

Preface to the Seventh Edition

Long distance trade has been taking place since pre-historic times. Evidences suggest that sea-route trade was prevalent during Indus Valley Civilisation, apart from those other civilisations. However, during those days the concept of “nation/country” did not exist. The concept of “nation-state” came into existence after the French Revolution (1789-99). However, there is another view that this concept was established in 1649 through English Commonwealth. Whatever, the genesis of this concept may be, it gave rise to competition among nations to increase cross-country trade on the one hand, and to protect their revenue by building fiscal and non-fiscal structures on the other. These gave rise to the concept of “international taxation” which is a subset of domestic income tax law which covers the transactions between persons of two countries. Since the law of one country cannot be extended to apply on the person or jurisdiction of another country; the same is governed by the agreement entered by the two countries. The agreement entered by both the country is called Double Tax Avoidance Agreement (DTAA) which defines the methods of sharing jurisdiction to tax, reducing evasion of taxes as well as ways to reducing/eliminating double taxation and avoiding litigation and supporting one another on administrative measures. Although the DTAA may help in deciding the taxing rights of the jurisdictions, the computational aspect is governed by domestic tax laws of the respective country. Unlike Indian income tax which characterise income under five heads of income, DTAA specifies separate article for the nature of transactions. In the changing business environment, many recent issues have evolved which made difficult for the identification of permanent establishment and attribution of business profit. Such transactions become even more complex when passive incomes are connected to such permanent establishment. In those conditions interplay of transfer pricing provisions may arise.

To protect the revenue base, India has developed Transfer pricing regulations more than two decades ago. The international transactions may be examined as per the TP regulation in accordance with the arm’s length principles. Finding the appropriate comparable, benchmarking of those transactions and reporting thereof involve a lot of intricacies. It has many issues like cases of restructuring, cost sharing arrangements, expenditure on marketing and promotions and expenditure on research & developments of intangibles etc., the transfer pricing adjustments of which may not be an easy exercise. In the present situation almost all the major countries have developed their own transfer pricing regulations.

In the changing business environment, the members are expected to have robust understanding of international taxation and transfer pricing. Since the members are expected to have practical understanding of the subjects, the Committee has adopted a case study-based assessment pattern for international taxation Assessment Test (INTT-AT).

I am grateful to CA. (Dr.) Debashis Mitra, President, ICAI and CA. Aniket Sunil Talati, Vice-President, ICAI for being the guiding force behind initiatives being taken by the Committee.

I whole heartedly acknowledge the contribution of CA. Ganesh Rajgopalan, Sree Lakshmi Valli, CA. Sachin Kumar in revision of the background material pertaining to “*International*

Taxation” which further reviewed by Past CCM. CA. Dhinal Ashwin Shah with the assistance of CA. Karan Sukhrmani.

We also thank CA. Arun Saripalli and his team members CA. Anand Kankani, CA Aman Agrawal, CA. Disha Kevin Vora, CA. Keyur Shah, CA. Mayur Chudasama, CA. Sumit Rathod, Tarun Mirchandani, CA. Vashishth Dave, CA. Nilesh Bangera and CA. Vipra Shetty who contributed towards the revision of the background material for the subject ‘*Transfer Pricing*’.

I, admire the guidance of Mr. S.P. Singh, Ex-IRS in reviewing the background material. Being an Ex-Deputy Secretary, Foreign Tax and Tax Research Division, CBDT his long experience can be perceived in this revised edition. As Director of International Taxation, Mumbai he was involved in implementation of the tax laws and his knowledge and experience in the area has added value to the publication.

I would also like to thank CA. Cotha S Srinivas, Vice-Chairman, Committee on International Taxation of ICAI for his support in all activities of the Committee. I gratefully acknowledge the support provided by the members of the Committee (including co-opted members) and special invitees; *Committee members*: CA. Chandrashekhar Vasant Chitale, CA. Vishal Doshi, CA. Purushottamlal Khandelwal, CA. Mangesh Pandurang Kinare, CA. Priti Savla, CA. Umesh Sharma, CA. Sridhar Muppala, CA. Rajendra Kumar P, CA. Sushil Kumar Goyal, CA. Rohit Ruwatia, CA. Anuj Goyal, CA. Gyan Chandra Misra, CA.(Dr.) Raj Chawla, CA. Pramod Jain, CA. Charanjot Singh Nanda, CA.(Dr.) Sanjeev Kumar Singhal, CA. Chhajer Piyush Sohanraji, Shri Ritvik Ranjanam Pandey, *Co-opted members*: CA. Avinash Gupta, CA. Rajat Sharma, CA. Mithilesh Sai Sannareddy, CA. Anup Kumar Sanghai, CA. Kaushik Mukerjee, CA. Nandkishore Chidambar Hegde, CA. Sanjay Bhattacharya, *Special invitees*: CA. Aseem Chawla , CA. Kriti Chawla Khanna, CA. Gaurav Singhal, CA. Sachin Sinha, CA. Manoj Kumar Mittal, CA. Smita Patni, CA. Ajay Rotti, CA. Akshay Kenkre, CA. Akshat Maheshwari, CA. Dilip Gupta, CA. Naman Shrimal, CA. Hari Om Jindal, CA. Deepender Kumar Agarwal, CA. Raju Kumar, CA. Parthasarathi Dasgupta, CA. Tejveer Singh, CA. Raj Kumar Nahata, CA. Parul Jolly, CA. Gaurav Geol, CA. Harpreet Singh, CA. Vikas Gupta, CA. Neha Gupta, CA. Surinder Kumar Kalra and CA. Geetika Gupta.

I also acknowledge the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation, and her team members CA. Dhiraj Shrivastav, Project Associate and CA. Harshita Sagar Jaiswal, Project Associate for co-ordinating the project and for rendering technical and secretarial assistance.

I am sure that this revised edition will help participants of the course to gain practical understanding of the subject.

Place: New Delhi
Date: 25.01.2023

CA. Sanjay K. Agarwal
Chairman,
Committee on International Taxation, ICAI

Foreword to the Sixth Edition

The world has been gradually moving towards digitalisation of business activities. COVID-19 has brought human tragedy and economic devastation which has been never seen before in our lifetime. Humanity is fighting tenaciously to defeat the pandemic resulting into paradigm shift in almost all walks of lives. Teleconferencing, which used to be novelty has become the regular way of doing business and communication. Technological advancements are being adopted at a speed not experienced in the recent times. All these changes are also the root cause for new challenges for tax advisors and tax administrations across the globe. Digitalisation of economies is altering the fundamental concepts of taxation. In order to make taxation more effective and efficient, India is taking several steps to simplify source based taxation which in turn makes the domestic law more transparent and certain. Recently, the law relating to taxation of payments for computer software, which had been a subject matter of litigation, has been settled by the Supreme Court of India; Similarly, the provision of dividend distribution tax was not free from litigation. The Finance Act, 2020 has abolished the dividend distribution tax as a result of which the incidence of taxation now lies in the hands of shareholder. Of late, sending positive message to foreign investors, the Taxation Laws Amendment Bill 2021, proposes to retract the retrospective amendment pertaining to Indirect transfers.

The transfer pricing law is becoming increasingly challenging due to unprecedented impact of COVID-19. Finding the comparable data, the most appropriate method and the arm's length price are significant challenges for all stakeholders. In these exceptional circumstances, OECD Guidance on the transfer pricing implications of the COVID-19 pandemic might be helpful. However, this guidance has not been yet adopted by many countries including India.

Since a lot has happened in the field of international taxation and transfer pricing during the recent years, members should have a comprehensive understanding of the concepts and changes in these areas. Understanding of domestic law appears to be incomplete without appreciating its interplay between treaties and Transfer Pricing Guidelines. This Background material on International Taxation and Transfer pricing is a comprehensive material which has been written and reviewed by eminent experts of the profession. For many years, Committee on International Taxation of ICAI has been effectively disseminated practical knowledge to members through this publication, which is revised annually.

I would like to appreciate Chairman, Vice-Chairman and all other members of Committee on International Taxation of ICAI under whose guidance the Committee on International Taxation has been taking various initiatives including series of refresher course, various panel discussions on important topics, revising publications and coming out with new ones so on and so forth. My best wishes for the members of ICAI!

Place: New Delhi

Date:31.08.2021

CA. Nihar N. Jambusaria

President, ICAI

Preface to the Sixth Edition

Amid the pandemic, the cross border digital payments in India have accelerated. The pandemic has further reinforced the businesses to go digital which is the need of business and economy. Now, the traditional brick-and-mortar businesses have also adopted the internet based digitalised business models to increase revenue through the customers located across the globe without paying any or negligible taxes in those countries. This had raised concerns for revenue authorities of various countries. Each country is trying to establish consensus to tax the Digital Economy. The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. Where pillar-one focuses on tax certainty while pillar-two allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The latest development is conceptual adoption of Minimum Global Tax by many countries. The final picture will emerge after the details of this concept are drawn.

Considering the recommendation, the Government of India has taken measures to tax the digital transactions by way of introduction of equalization levy on sale of goods & AMP; services by e-commerce operator, redefining the scope of business connection to curb the issue of digital PE. Along with these, like in many jurisdictions, measures are being adopted through amendments in domestic law as well as in tax treaties with the help of Multilateral Instruments to avoid manipulation of clauses on permanent establishment and other clauses. Concepts like Principal Purpose Test, Limitation of Benefits, and measures against unjustified splitting of activities etc. are being adopted. Apart from this, the Government has also taken various other measures to provide tax certainty to the taxpayers. Earlier the Government had introduced the faceless assessment scheme, Vivad se Vishwas (VSVD) scheme to end up the long pending litigations. In addition to this, in order to provide pace in the decisions of AAR, the Authority for Advance Rulings has also been reconstituted. Recently, the Taxation Laws (Amendment) Bill 2021 has been introduced to provide exemption from indirect transfer of Indian assets made before certain period. The Government has also come out with the new e-filing portal with the features of less documentation leading to fast processing time.

Considering the rapidly evolving subject; understanding the impact of domestic law and treaties has become a necessity for the members of ICAI. In order to update the knowledge of its members and to provide learning knowledge the Committee on International Taxation, ICAI has come out with various publications on many important subject of international taxation. However, to have a comprehensive understanding of the subject; this Background Material of Diploma in International Taxation has proved to be a one stop shop, written and reviewed by veterans in the profession.

I am sincerely thankful to President, ICAI and Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

I also whole heartedly acknowledge the efforts of CA. Dhinal Ashwin Shah who actively assisted by CA. Karan Sukhrmani, for revising the Background material pertaining to International Taxation. We are also thankful to CA. Arun Saripalli who was actively assisted by CA. Abhishek Gupta and Ronak Jain in the revision of the background material pertaining to the subject of Transfer Pricing.

I, highly, appreciate the efforts put in by Mr. S.P. Singh, Ex-IRS in reviewing the background material. While working as Deputy Secretary, Foreign Tax and Tax Research Division in the CBDT Mr. Singh, participated in framing laws for non-residents and participated in negotiation of approximately 30 tax treaties. He was also, the first Director of Income Tax (International Taxation), Mumbai. He was one of the members of the Expert Group set up by the government for drafting Transfer Pricing regulations. His long experience in the areas of International Taxation and Transfer Pricing has rewarding impact on the material. We also thank CA Sharad Goyal and CA. Ankit Arora who actively supported Mr. S.P. Singh in this task.

With the efforts of all of them, the Committee was able to come out with the revised edition in a timely manner.

I am also grateful for the unstinted support provided by Vice-Chairman CA. N.C. Hegde and other members (including co-opted members) and special invitees of the Committee on International Taxation;

Last, but not the least, I appreciate the efforts made by the Secretariat, Committee on International Taxation for co-ordinating the project and for rendering secretarial assistance.

I am hopeful that this revised edition will be of immense use to the members.

Place: New Delhi
Date: 31.08.2021

Chairman,
Committee on International Taxation, ICAI

Foreword to the Fifth Edition

The globalized economy has fostered the growth of multinational and transnational enterprises, leading to a massive increase in the volume and nature of cross border trade and transactions. While international trade and commerce has grown manifold, the international tax framework, designed more than a century ago is proving to be inadequate in dealing with such transactions, thereby creating opportunities for Base Erosion and Profit Shifting (BEPS) between Countries. The introduction of Multilateral Instrument (MLI) has enabled countries to revise tax treaties bypassing the regular time taking process of revising tax treaties. It will go a long way in preventing Base Erosion and Profit Shifting. International organisations like United Nations and Organisation for Economic Cooperation and Development are endeavouring to develop internationally acceptable approach to tax Digital Economy.

Appreciating that a good tax system not only discourages revenue leakages, but is effective, efficient, equitable and economical, India has proactively taken measures like developing smoother tax filing mechanism, establishing computer generated documents identification system, introducing e-Assessment system, and granting relaxation from filing of returns in certain specific cases etc. These steps and initiatives will help build an atmosphere of trust between taxpayers and tax authorities.

As the importance of international taxation is growing it is need of the hour for the members of ICAI to develop expertise to take up the professional opportunities in this area. The ICAI through its dedicated Committee on International Taxation has been imparting knowledge to the members of ICAI to enhance their knowledge to enable them to provide high quality professional services.

I would like to express my gratitude to CA. Nandkishore Chidamber Hegde, Chairman and CA. G. Sekar, Vice-Chairman and all other members of Committee on International Taxation of ICAI for taking various initiatives in the field of International Taxation for the benefit of members and other stakeholders. Timely annual up-dation of the Background material of the Diploma course is one of the commendable accomplishments of the Committee.

I am sure that this Background Material would be of immense use for the participants of the Diploma in International Taxation.

Best Wishes,

Place: New Delhi

Date:31.08.2020

CA. Atul Kr. Gupta

President,ICAI

Preface to the Fifth Edition

With recent rise in the digital transactions, the old brick-and-mortar business is now outdated. The business models are evolving rapidly along with the technology and it becomes important to understand the impact of technology on business model from taxation perspective. In digital transactions, the global economy is swiftly intertwined with the traditional economy by digital means, thus making it harder to create a clear delineation of the true meaning of a digital economy. Both developed and developing countries are struggling to develop an effective and efficient system of taxation of Digital Economy, which would be internationally acceptable and would address the possibilities of double taxation and double non-taxation. As international consensus is awaited, many countries have, unilaterally, imposed taxes on such economic transactions. In line with this approach, India has introduced Equalisation Levy for the taxation of digital economy.

An important consequence of the growth of Digital Economy is that it is now possible for an enterprise resident in one State to be substantially involved in another State's economy without a permanent establishment or fixed base in that State and without any substantial physical presence in that State. This makes the present taxation system in almost all countries inadequate in bringing such transactions within tax net.

Considering the rapidly changing laws pertaining to international Taxation and the complexities involved, ICAI through its Committee on International Taxation organises Diploma in International Taxation so as to ensure that the members of ICAI are able to enhance their knowledge in this area. Considering the present situation due to pandemic, the course is now being organised online. The course takes care of International Taxation as well as Transfer Pricing.

Every year changes which are announced by the Finance Act as also changes in International tax laws are incorporated in the Background material of the course. This year also, the Committee has revised and updated the material to include all the recent amendments made by the Finance Act, 2020 like: deemed residency, equalisation levy, dividend distribution tax etc. The objective of this course is to provide our members update information about all the happening in the world of international taxation and to enable them to provide best professional services in the industry.

I also whole heartedly acknowledge the efforts of CA. Dhinal Ashwin Shah who actively assisted by CA. Karan Sukhramani, for revising the Background material pertaining to International Taxation. We are also thankful to CA. Arun Saripalli who was actively assisted by CA. Tarun Bindlish and CA. Anurag Agrawal in the revision of the background material pertaining to the subject of Transfer Pricing. I, highly, appreciate the efforts put in by Mr. S.P.

Singh, Ex-IRS in reviewing the background material. His long experience in the area of International Taxation and Transfer Pricing has rewarding impact on the material. We also thank Mr. Ankit Arora who actively supported Mr. S.P. Singh in this task.

With the efforts of all of them, the Committee was able to come out with the revised edition in a timely manner.

I am also grateful for the unstinted support provided by Vice-Chairman CA. G. Sekar and other members (including co-opted members) and special invitees of the Committee on International Taxation; CA. Tarun Jamnadas Ghia, CA. Chandrashekhar Vasant Chitale, CA. Dayaniwas Sharma, CA. Rajendra Kumar P, CA. Sushil Kumar Goyal, CA. Anuj Goyal, CA. Kemisha Soni, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, CA. Pramod Jain, CA. (Dr.) Sanjeev Kumar Singhal, CA. Charanjot Singh Nanda, Shri Manoj Pandey, Shri Chandra Wadhwa, Dr. Ravi Gupta, CA. Sachin Sastakar, CA. T.P. Ostwal, CA. Ujwal Nagnath Landge, CA. B. M. Agrawal, CA. Nidhi Goyal, CA. Kirti Chawla and CA. Amar Deep Singhal.

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and CA. Dhiraj Shrivastav, Project Associate for co-ordinating the project and for rendering secretarial assistance.

I am hopeful that this revised edition will be of immense use to the members.

Place: New Delhi

Date: 31.08.2020

CA. Nandkishore Chidamber Hegde

Chairman,

Committee on International Taxation, ICAI

Foreword to the Fourth Edition

Developments in the area of International taxation have considerably impacted the multinationals as well as the tax authorities. The multinationals are gearing up for a tax regime driven by an agenda to curb the Base Erosion and Profit Shifting (BEPS) while the tax authorities in India are taking the lead in implementing tax measures that are now being looked at by more developed countries.

Since the developments in International taxation have opened up a plethora of opportunities for professionals, our members need to update the requisite skill sets professionally to help the stakeholders in investing both domestically and internationally. The Institute of Chartered Accountants of India (ICAI) through its Committee on International Taxation has been taking various steps so as to enable our members to keep a tab with the emerging developments in the area of international taxation for effective discharge of their responsibilities towards the stakeholders.

I congratulate CA. Nihar N. Jambusaria, Chairman and CA. Pramod Jain, Vice-Chairman, Committee on International Taxation of ICAI for taking various initiatives in the field of International Taxation for the benefit of members and other stakeholders at large. I appreciate timely and regular updation of this background material which is an integral part of Diploma in International Taxation being organised by the Committee.

I am sure that this revised publication would be of immense use to the participants of Diploma Course. I wish the participants of the course a very delightful learning experience.

Best Wishes,

Place : New Delhi

(CA. Prafulla P. Chhajed)

Date : November 15, 2019

President

Preface to the Fourth Edition

In this dynamic world where there is constant free flow of cross border investments, knowledge and human capital, international tax assumes an important role. Significant changes in the law keep the regulators as well the assesseees on their toes. Our members, being tax professionals, too are required to keep themselves updated in the area. Thus, training is imparted to them, on regular basis, through the Diploma in International taxation organised by the Committee on International Taxation of ICAI.

In tandem with the updated knowledge being imparted through this Diploma course, the Committee every year updates its background material. Once again efforts have been made this year to revise the background material in a timely manner. Apart from the same the Committee is also working on various new publications which will be released over the period of time.

I am sincerely thankful to CA. Prafulla Premasukh Chhajed, President and CA. Atul Kumar Gupta, Vice-President of the Institute of Chartered Accountants of India for being a guiding force behind the activities being undertaken by the Committee.

I am appreciative of the efforts put in by CA. Pramod Jain, Vice-Chairman of the Committee and also other Committee Council members, CA. Tarun Jamnadas Ghia, CA. Nandkishore Chidamber Hegde, CA. Chandrashekhar Vasant Chitale, CA. Aniket Sunil Talati, CA. Dayaniwas Sharma, CA. G Sekar, CA. Pramod Kumar Boob, CA. Satish Kumar Gupta, CA. Hans Raj Chugh, Shri Sunil Kanoria, Shri Chandra Wadhwa, Dr. Ravi Gupta, co-opted members CA. T.P. Ostwal, CA. Padam Khincha, CA. Ameya Kunte and CA. Yogesh Thar who have contributed towards revision of this Background material.

I also appreciate the efforts of CA. Dhinal Shah supported by CA. Twinkle Shah and CA. Karan Sukhramani who undertook the task of revising the background material pertaining to International taxation. I am also thankful to CA. Arun Saripalli supported by CA. Sunny Kishore Bilaney and CA. Leena Chhabria for their contribution towards the revision of background material pertaining to Transfer Pricing. This joint effort has enabled the Committee to come out with the revised version of the background material in a timely manner.

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and her team for co-ordinating the project and for rendering secretarial assistance.

I believe that this background material would be helpful to the members not only for their examination but also in discharging their professional responsibilities.

Place: New Delhi

Date: November 14, 2019

CA. Nihar N. Jambusaria

Chairman,

Committee on International Taxation, ICAI

Foreword to the Second Edition

Globalisation has greatly impacted the economies of various Countries and their tax policies. There is a huge flow of funds across the nations, which needs to be monitored from various perspectives. Tax evasion is one of the important perspectives which required OECD on request of G20 countries to work on implementation of Base Erosion and Profit Shifting (BEPS) action plans.

Since there is difference in the tax rates across the countries BEPS was adopted by many multinationals. India too witnessed huge inflow and outflow of funds through tax haven countries like Mauritius. Sincere efforts are being made by the Government to plug all the loopholes which lead to loss of revenue to the Indian exchequer. Negotiations to amend DTAAs, implementation of GAAR and POEM, Cbc reporting are examples of some of the steps being taken in this direction. Further, in order to tackle treaty abuse, India has recently signed the multilateral Instrument (MLI). The MLI will be applicable alongside the existing tax treaty with the required changes, without any further bilateral negotiation between the countries concerned.

The ocean namely “International taxation” is much deeper than “domestic taxation”. Sailing safely through it requires, will, knowledge, experience, and the ability to learn and keep oneself updated. The Committee on International Taxation of ICAI under the able chairmanship of CA. Sanjiv Kumar Chaudhary has been taking all efforts to educate the members in the area of International taxation. Infact considering the need and importance of International taxation in today’s time, the subject has also been included in the new curriculum of Chartered Accountancy course.

I would like to express my whole hearted gratitude to CA. Sanjiv Kumar Chaudhary, Chairman and CA. Nand Kishore Hegde, Vice-Chairman, Committee on International Taxation of ICAI for taking various initiatives through the Committee to keep the members updated in the field of International taxation. Revision of this publication is one of the important tasks accomplished by the Committee.

I am sure that this revised publication would be of immense use to the registrants of Diploma Course. I wish the registrants of the course all the very best for their future.

Best Wishes,

Place: New Delhi

Date : 20.07.2017

CA. Nilesh Shivji Vikamsey

President, ICAI

Preface to the Second Edition

Opening up of vast consumer base, economic potential and financial reforms has led to increase in investment in almost every sector of the Indian economy. Today, India is preferred over other developing countries for cross border investments. Increase in cross border trade and rendering of services, has further lead to various taxation issues which are interesting and also complex. Enormous increase in the digital transactions has further added to the complexities involved in taxation thereof. For the Government to have its fair share of taxes has become a challenge in itself. Successful implementation of BEPS Action plan is the only probable solution to the issue.

For broad and consistent implementation of BEPS the Inclusive Framework was established in June 2016. Nearly 100 countries and jurisdictions have become members since then. To cater to issues of tax avoidance, various countries including India have commenced implementation of some of the BEPS action plans. Further, to strengthen tax treaties the concept of multilateral Instrument has been brought in. India too is committed to address the issues of tax evasion and thus has signed this multilateral Instrument recently in June, 2017.

Since International Taxation has been assuming importance rapidly, gaining knowledge in this area has become a necessity. This area of practice has great prospects in the today's time and also in the years to come. It has always been the endeavour of ICAI to provide necessary support to its members to update themselves in such upcoming areas. Efforts are made through various means like sending updates to members on regular basis, organising of webcasts on recent issues in International Taxation, bringing out e-newsletter on quarterly basis, bringing out new publications and revising the existing ones and so on.

One such effort in this direction is organisation of Post Qualification Diploma in International Taxation on regular basis in all parts of the country by the Committee on International Taxation. The Committee launched this course in the year 2016 and has received overwhelming response from the members. With this course the Committee endeavours to strengthen the knowledge base of the members who practice in the area of International taxation as well as members who aspire to do so.

I am thankful to CA. Nilesh Shivji Vikamsey, President and CA. Naveen N D Gupta, Vice-President for being the motivational force behind the efforts being taken by the Committee.

The Study material for the course, developed by over 40 experts, has also been appreciated. Since taxation is a dynamic area, every year up-dation of the study material becomes a necessity. Thus, the Committee has come out with the revised second edition of the study material. The recent developments in the area have been taken care of.

I place on record my sincere thanks to the Vice Chairman, CA. N.C.Hegde who not only undertook revision of the publication but has actively supported all endeavors of the

Committee. I am also thankful to all the Committee members for sharing their experience and knowledge for creating awareness about the subject of International Taxation.

It is indeed a pleasure to convey my gratitude to CA. N. C. Hegde supported by CA. Mallika Apte, CA. Paras Modi, CA. Richa Gandhi, CA. Jhankana Thakkar and CA. Miloni Mehta; CA. Nihar N. Jambusaria supported by CA. Kushal Shah and CA. Shyam Ambani; CA. Dhi nal Shah supported by CA. Ashwin Vishwanathan and CA. Ankit Bansal; CA. Rahul Garg supported by CA. Saurav Bhattacharya; who took untiring efforts to revise this study material in a timely manner. I also appreciate the efforts of CA. Parul Mehta; CA. Mrugen Trivedi; CA. Madhavi Mandovra ; CA. Hetal Mehta; CA. Nidhi Khanna; CA. Vinaya Phanse; CA. Shruti Agarwal; CA. Radhika Mangla; CA. Surbhi Mahendru; CA. Alpesh Shete; CA. Shailendra Dhole; CA. Anuradha Rathod; CA. Karnik Kansara and Bhavesh Hodar who supported me in revising the portion assigned to me by the Committee.

Special thanks to CA.P.V.SS Prasad; CA. T.S.Ajai and CA. Arun Saripalli who took the enormous task of reviewing the revised material in a short span of time.

I would also like to extend my appreciation to CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation of ICAI and her team for providing technical and administrative support in revising this study material. I am sure that this study material would be able to bring conceptual clarity to the members, which, is indeed the need of the hour.

Place: New Delhi

Date: 20.07.2017

Chairman

***Committee on International Taxation of
ICAI***

Foreword to the First Edition

The globalization of Indian economy and the progressive development that has taken place in recent years have offered strong incentive to multinational corporations to enter into Indian business space on their own or by engaging through domestic partners. This has led to various developments in the field of taxation and has generated interest in the Indian tax system by multinational corporations and their professional consultants. In fact, globalization, capital mobility and the increased trade and services has made international taxation a key concern area both for business enterprises engaged in the cross-border transactions and the tax administrations of the concerned states.

These developments have paved way for an additional area of expertise in practice for our Chartered Accountants. The Institute has always supported its members by updating their knowledge and professional skills so as to enable them to face such new challenges. ICAI introduced the Certificate Course on International Taxation in the year 2008 to provide focus attention in the evolving area of International Taxation. I am sure that the members who have pursued that course would vouch for the splendid work done by the Committee on International Taxation in all these years.

In order to give more value to the members, committed efforts have been made all these years to convert the Certificate course into Diploma. I am glad to mention that due to its unstinted efforts to provide the best to its members, ICAI had in the year 2015 received a approval from the Ministry of Corporate Affairs for conducting Diploma in International Taxation. The Committee on International Taxation has been taking all possible efforts to launch this course in the most efficient manner. This study material is one such effort in this direction. I congratulate CA. Nihar N. Jambusaria, Chairman and CA. Sanjiv Chaudhary, Vice-Chairman and all other members of Committee on International Taxation for bringing out this Study material for the participants of the course. In fact an important milestone shall be successfully achieved with its release.

I am sure that this comprehensive background material, which is specifically designed for the Diploma Course, will certainly provide an insight into the complex aspects of International Taxation in a very lucid manner.

Date: 1st May, 2016

Place: New Delhi

CA. M. Devaraja Reddy

President, ICAI

Preface to the First Edition

Since the opening up of the Indian economy in 1991, India has seen a huge inflow of capital in the form of foreign investments. With each passing year, the Government has taken further steps to ensure that India integrates with the global economy. The advent of economic reforms in the form of globalization and liberalization in our country has resulted in the rapid growth of the Indian economy in general and cross border transactions in particular. The process of globalization is set to gain further impetus with the good performance of the economy in recent past. There has been manifold increase in the cross border activities of multinational corporations and other non-residents in the manufacturing and service sectors of the economy.

All the above developments have a great impact on taxation of the transactions arising out of such activities. Thus, international taxation has steadily become a major area of professional interest. However, the concepts and issues concerning international taxation are of a complex nature. Realizing the importance of the subject, the Committee on International Taxation of ICAI had taken an initiative earlier in the year 2009 by introducing Certificate Course on International Taxation. Till date 44 batches have been conducted all over India.

Since ICAI has received approval from Ministry of Corporate affairs for conducting Diploma in International Taxation, the Committee on International Taxation is now making its unstinted efforts to launch the same. In this effort, CA. Manoj Fadnis, President, ICAI and CA. M. Devaraja Reddy, Vice- President, ICAI were the guiding force for the Committee. I place on record my sincere thanks to them on behalf of all the members of the Committee. I am also thankful to Vice Chairman, CA. Sanjiv Chaudhary and all Committee members for supporting me in such an important initiative of the Committee. The Committee also took the inspiration, encouragement and guidance of CA. T.P.Ostwal ji for which I am grateful to him.

The first and the most important step in the launch of this Diploma was preparation of the study material. The Committee had various meetings to finalise the syllabus, structure and the contributors to the Background material. It is heartening to mention that about forty senior International tax professionals have generously contributed to this material. Thereafter, the material was vetted by the stalwarts in the profession. From the bottom of my heart, I thank all authors; CA. Vijay Iyer, CA. Pallavi Dinodia, Mr. S P Singh, Mr. Gaurav Bhutani, CA. Mukesh Buttani, Mr. Sunchit Majumdar, CA. Sandeep Puri, CA. Rajan Sachdev, CA. Hardev Singh, CA. Nidhi Khanna, CA. Madhavi Mandovra, CA. Dhishat B. Mehta, CA. Yashodhan Pradhan, CA. Mayur Nayak, CA. Tarun Chaturvedi, CA. Tarun Singhal, CA. Anil Doshi, CA. K.R. Girish, CA. Rajesh Simhan, CA. Nilesh Kapadia, CA. Prashant Maheshwari, CA. Neetu Vinayek, CA. Kedar Karve, CA. Paresh P. Shah, CA. Amrish Shah, CA. Sonu Iyer, CA. Preeti Sharma, CA. Mayur Desai, CA. Dhigesh Rambhia, CA. Hariram Gilda, CA. K.R. Sekar, CA. Manju Bhardwaj, CA. Ashesh Safi, CA. Sunil Kapadia, CA. NatwarThakrar, CA. Paresh Parekh, CA. Dhinal Shah, CA. Nisha Shah, CA. Parul Mittal, CA. C A Gupta, CA. Romesh Sankhe, and

reviewers CA. N.C. Hegde, CA. Pinakin Desai, CA. Mayur Desai, CA. Vishal Shah, CA. Rajan Vora, CA. T.P. Ostwal, CA. Arun Saripalli, CA. Sudhir Nayak, CA. Rajan Vora for their untiring efforts, contributions and valuable inputs by authoring the material. I also place on record the efforts of CA. Basant Porwal and CA. Vinay Baloda who undertook the tasks of overall review of this material.

I also appreciate the efforts of CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation of ICAI and Mr. Ashish Bhansali, Assistant Secretary for providing technical and administrative support in giving final shape to this study material. I am confident that this comprehensive study would be of immense use to the members and would provide conceptual clarity regarding the basics of International taxation.

Date: 1st May, 2016

Place: New Delhi

CA. Nihar N. Jambusaria

Chairman,

Committee on International Taxation of ICAI

SYLLABUS

Broad Objective

- (a) To gain working knowledge of the provisions of International taxation laws.
- (b) To acquire an analytical approach to apply the working knowledge to specific problem areas in a variety of practical situations.

Paper 1 - International Tax –Practice

- (a) Provisions of Income-tax Act, 1961 and Income tax Rules, 1962, relevant to International Tax in India, Principles of International Taxation, Double Taxation Avoidance Agreements, Tax Information Exchange Agreements, Anti-Avoidance Measures etc
- (b) Model Tax Conventions (UN, US and OECD), Basics of International tax Structures, International Financial Centre, other issues in International Taxation which may arise from time to time like digital economy & e-commerce, financial Instruments and Trusts etc.
- (c) Any new legislation having impact on International Taxation, introduced from time to time

Note:

1. The participant will have to undergo will have to undergo 126 hours International taxation Professional Training (INTT PT) through physical sessions OR 84 hours through online mode which would cover the above-mentioned syllabus. Considering the dynamic nature of International taxation, the Committee on International Taxation be authorized to make changes in the said curriculum within the broad framework of above-mentioned syllabus as approved by the Council.
2. If new legislations are enacted in place of the existing legislations the syllabus will accordingly include the corresponding provisions of such new legislations in the place of the existing legislations with effect from the date of its notification or effectiveness.

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An Overview of International Taxation

1. Introduction to International Taxation

1.1 Introduction

Every country wishes to function in a manner which helps achieve the desired objectives which include:

- (i) economic growth/development
- (ii) uplifting the socially weaker sections and generation of employment etc. to achieve one of its major sources of revenue which is collection of taxes. The incidence of tax in a country may be on its citizens, residents or non-residents. In Economics, Tax incidence or Tax burden is the analysis of the effect of a particular tax on the distribution of economic welfare. Tax incidence is said to “fall” upon that group which ultimately bears the burden of, or ultimately has to pay, the tax¹.

The history of taxation is almost as old as that of civilization. Oliver Wendell Holmes, once said, “I like to pay taxes. With them I buy civilization”. Taxes have existed in all ages, only its character and ways of implementation have changed. Like scientific discoveries, nature of business, nay income, has changed more rapidly in the last a couple of decades than during centuries in earlier days. Now income can be generated in a location without physical presence. The digitalization is changing the way we live, behave and most importantly, earn. These are making our lives more comfortable but adding challenges to the tax advisors and more crucially to the tax policymakers and tax administrators.

Black Law Dictionary (11th Edition) quotes John F. Dalton: “Taxes (including, in the term, assessment) are burdens or charges imposed by the legislature, or under its authority, upon persons or property, to raise money for public, as distinguished from private purposes, or to accomplish same end or object public in its nature.” Taxes so raised are for the public benefits. Nearly 2000 years ago there was a decree from Augustus Caesar that “all the world should be taxed”. In ancient Greece, Germany and the Roma Empires taxes were levied on the basis of occupation. In Northern England taxes were levied on land and movable properties. Taxes are levied by almost every country in the world.

Normally, taxes which are levied are of two types: (1) Direct Taxes and (2) Indirect Taxes. The power to levy taxes has to be expressly provided by the laws of the country. **In the Indian context, the Constitution of India under Article 265 expressly provides that “Taxes not to be imposed save by authority of law. No tax shall be levied or collected except by**

¹ Wikipedia, the free encyclopedia

authority of law” (emphasis supplied). It should be noted that the laws which are formulated should adhere to principles laid down in the Constitution. Taxes serve as the primary means for various important objectives including maintaining law and order, public infrastructure, financing subsidies, setting up educational institutions, incentives, research and development etc.

1.2 Brief Look at the History of Taxation System in Different Countries

The history of taxation is as old as that of civilization. However, its form and extent have been varying over countries and over time in the same country. The taxation system of a country is, basically, dependent upon technology, ways of carrying on business, social and economic factors of the population. With globalization, it is now, with increasing effect, dependent upon various international factors. An important feature of international trade is development of interdependence of economies. This has made role of international organisations like G-20, the OECD (Organisation for Economic Cooperation and Development) and United Nations, crucial in developing taxation rules which protects interest of countries and, at the same time, has maximum acceptability.

The concept of (a) Levy (b) Computation and (c) Collection of tax is different in different countries of the world. The system of levy of tax on a standalone basis, in each country was a self-contained code. However, in the late nineteenth and early twentieth century, when foreign trade was expanding, different jurisdictions started interacting with each other. Such interactions led to harsh consequences of jurisdictional double taxation, i.e. tax was levied in the country of source (COS) and also country of residence (COR) on the same income without any relief of any kind. Domestic tax laws being unable to fully resolve issues of double taxation, a need was felt to determine the basis on which a country should exercise its right to tax. This eventually led to evolution of “Double Tax Avoidance Agreement” (DTAA/ tax treaty) which, on the one hand, limited / modified the rights under domestic tax laws of a country to a certain extent in order to respect the rights of other Countries and on the other provided for exemption or reduction of double taxation, normally, by the country of residence. Besides avoidance of double taxation, DTAA's seek to develop economic relations so as to enable flow of capital, technology, know-how, exchange of information, assistance in collection of taxes etc., between the treaty partner countries.

1.2.1 Present Scenario

Generally, in cross border economic transaction(s), tax laws of two or more countries are usually triggered. The term “International Taxation” refers to interplay of tax laws applicable to cross border transactions in the countries involved as well as international understanding on taxation of such transactions. These understanding are developed by international organisations such as Organization for Economic Cooperation and Development (OECD) and United Nations (UN). It needs to be noted that there does not exist a separate international tax code. Every country formulates tax policies and enacts tax laws depending on its wisdom. The principles of international taxation are very similar to the concept of tax. It includes concepts of tax equity and neutrality.

- **Tax equity**

- (i) Each country whose residents are a party to a contract or a country being a source country must be entitled to its fair share of revenue;
- (ii) Taxpayers involved in the cross border transactions must not be saddled with additional levy of tax which results in discrimination nor there shall be given any undue preference which is otherwise not available.

- **Tax neutrality**

- (i) **Capital export neutrality**

The underlying intention is that investment decisions must not be affected due to tax factors. To elaborate more clearly, it can be said that this philosophy supports the principle that investment must be on pure commercial considerations which is possible when the investor faces the same tax burden wherever he chooses to invest. Tax effects, although impact the cash flows of a business, must remain at the backseat while an investment decision is made. This enables a businessman to select a location which fetches maximum pre-tax returns to the business.

Let us understand this with an illustration:

A. Ltd. (Indian resident)

(Amount in Millions)

Particulars	India (Tax rate 30%)	United Kingdom (UK) (Tax rate 40%)
Sales revenue	3000	3000
Less - Total Cost of operations	1700	1500
Profit before tax for the year	1300	1500
Less - Tax payable	390	600
Net Profit After Tax	910	900

From the above, it can be seen that the pre-tax return in UK exceeds the pre-tax return earned in India. Therefore, the concept of capital export neutrality provides that A Ltd. shall carry out its operations from UK.

Note

However, in reality, it is known that A Ltd. is more likely to opt for carrying out its activities in India because the after tax return available in India is higher compared to after tax return earned in UK.

- (ii) **Capital import neutrality**

This philosophy is completely different from capital export neutrality. Here, it is provided that all the investments in a given country must pay the same amount of tax regardless of the residential status of the investor. In other words, a non-resident in comparison to a resident carrying on business in India must pay tax at the same level for the same income in India.

(iii) National neutrality

Here, from a national perspective, it supports the philosophy that even income earned from source outside the resident country must be taxed. However, there shall be allowed relief from taxes paid in the foreign country for foreign taxes paid in the manner in which deduction for other costs is allowed. A tax system with this feature will make investors indifferent between the pre-tax return on domestic investments and the return on foreign investments after paying foreign taxes. The key difference between capital export neutrality and national neutrality is the treatment of foreign taxes.

Capital export neutrality concept treats a foreign government receiving taxes on par with the home country government while national neutrality concept counts only tax payments to the home country as improving welfare. The national neutrality principle recognizes that the home country would prefer to receive taxes which it can use for social welfare rather than another country receiving those taxes and would not be indifferent between the two alternatives.

• Some Features of International Taxation

International taxation involves interplay of two or more tax systems on account of the cross border economic transactions. International taxation system not only refers to levy of taxes by two or more countries but also includes, inter-alia, the following:

- (i) Allocation of taxing right to the country of source and country of residence
- (ii) Elimination of double taxation
- (iii) Promotion of economic relations between the contracting states
- (iv) Determination of residential status of taxpayers in case when difficulties arise in determining the same residential status of the taxpayer.
- (v) Forming Anti Avoidance measures (Example:-Transfer pricing regulations, exchange of information,)

1.3 Evolution of Taxation System in India

India taxation goes back to the ancient times. We come across the word “*kara*” in Srimad Bhagvatam and ‘*bh gadugha*’ (the tax collector) in the Vedas. The first specific mention of tax in the written history in India is in The Arthasastra, which mentions both direct and indirect taxes. It emphasises that the king is only a trustee of the land. During those days land revenue was the major source of revenue for the king. The precursor of “*lagaan*” was the system introduced by Emperor Krishnadevaraya (1509–1529) where the amount of tax levied depended upon the income of the farmer and was increased only if the income increased. Taxes during the medieval period consisted of land revenue and taxes on manufacturing sector.

In modern India for the first time Income Tax Act was introduced in 1860 by James Wilson, the first Finance Minister of the Government of India. It was divided into 21 parts of 250 sections. The Financial Year commenced on 1 August 1860. Paradigm shift in the annals of taxation happened when based on the experiences and reports of various committees revised Income-tax Act, 1922

was introduced. It was used to frame Income-tax Act, 1961, again drawing materials from various committees and commissions.

Further, the decisions pronounced by Courts of law also have had its own share of significant influence in the functioning of the legal system in India. Let us have a brief overview of the evolution of Income Tax Act, 1961 in India².

1.3.1 Enactment of Income Tax Act, 1961 and Tax Reforms prior to 1991

³The erstwhile Income Tax Act, 1922, due to various changes in the law and many other factors had become a complicated subject. It was the need of the hour to come up with a new law which would replace the existing system of taxation with simple provisions, ensuring voluntary compliance, preventing tax evasion, making more revenue oriented and also reducing the cost involved in collecting and ensuring adherence to the law. The following events took place in the chronological order -

- The Law commission set up by Government of India in 1956 submitted its report in the year 1958.
- Direct tax enquiry committee was also set up to address the issues faced by the assessee. This committee submitted its report in 1959.
- A new law was proposed under the supervision of Prof. Nicholas Kaldor.
- Income Tax bill 1961 was proposed in the Lok Sabha.
- It was passed by Parliament in September 1961 and the Income Tax Act, 1961 came into force from 1st April, 1962.
- Income Tax Act, 1961 as it was enacted contained twenty-three (23) chapters, two hundred ninety-eight (298) sections and fourteen (14) schedules.
- In addition to the above, apart from the Finance Acts which amended the Income Tax Act, 1961 from time to time, various Amendments such as Taxation Laws Amendment Act 1984, Direct Taxes Amendment Act, 1987, Direct Taxes Law (Amendment) Act, 1988 and 1989, Direct Taxes Law (Second Amendment) Act, 1989, Taxation Law (Amendment) Act, 1991 etc. also has had its impact on the Income Tax Act, 1961.

1.3.2 Tax Reforms post 1991

The year 1991 has been a year of events which has changed the course of India's path towards development. Rationalization of economic policies was the major reform witnessed ever in the history of independent India. However, tax reforms also had its own fair share of impact on the economy of the country. The following are some of the key changes in the Income tax system of India post 1991:

² The decisions of the Court having an effect on the taxation structure is discussed as and when considered necessary.

³http://shodhganga.inflibnet.ac.in/bitstream/10603/2876/8/08_chapter%201.pdf

- In relation to the personal income tax, the maximum marginal rate was and is being drastically reduced.
- Tax slabs have been restructured with low tax rates⁴ and exemption limits have been raised.
- Corporate tax rates for domestic and foreign companies were also reduced significantly.
- Concept of source rules and gross based taxation of income, such as dividends, interest, royalty, and fees for technical services in the hands of non-residents was introduced by the Finance Act, 1976.
- Depreciation on intangible assets was introduced for the first time on or after 1st April 1998⁵.
- Minimum Alternate Tax policies rationalization⁶, Dividend distribution tax, Securities Transaction Tax, etc.
- Transfer pricing provisions were introduced to safeguard the Indian tax base and curb the practice of artificial shifting of profits by manipulating the prices of goods and / or services.
- Concept of substance over form has found a footing in various sections of Income Tax Act, 1961. Recent example being the General Anti-Avoidance provisions which possess the capability of disregarding the legal form of any transactions which are entered into for the purpose of gaining tax advantages.
- Transfer Pricing regulations were introduced in 2001.
- Income Computation and Disclosure Standards (ICDS) provisions have been made effective retrospectively from 1 April 2017 and shall apply in relation to assessment year 2017-18 and subsequent assessment years.
- Corporate tax rates have been reduced significantly with exemptions and deductions to be phased out gradually from 1st April, 2019 onwards
- Concept of significant economic presence⁷ in India, has been introduced in order to create a business connection of foreign enterprise earning revenue on account of having prescribed number of users in India or prescribed amount of revenue from India operations.

1.4 Conclusion

- Law should not be static, it has to be dynamic and the law makers should adopt policies which can also be capable of taxing the new method business models adopted by the

⁴ Note that personal income tax during the time when Mrs. Indira Gandhi was the Prime Minister of the Country was as high as 97.50% comprising of as high as 11 tax brackets

⁵ Section 32(1)(ii) of Income Tax Act, 1961.

⁶ Report submitted by Justice A. P. Shah

⁷ Explanation 2A to section 9(1)(i)

people. Taxation laws were, initially, enacted in the earlier days when the conventional methods of business practices such as trading, manufacturing of goods, etc. formed major part of the GDP of India.

- Today, the service sector has also gained significant importance. Also, the conventional methods of doing business have undergone a radical change due to introduction of technology (example – digital commerce where goods can be bought and sold without requiring a fixed place of business).
- New laws and policies are enacted to give effect to some intent and purpose. Similarly, one can see that the Income Tax Act, 1961 as enacted in the year 1961 to the present day, has gone through a series of changes. These changes were made to give effect to the purpose of economic development, ensure that the provisions of law are not defeated by using artificial tools of tax avoidance, and ensure tax equity and neutrality.
- The basic concepts of taxation, particularly, international taxation needs to be re-examined in view of digitalization of economy. Now the existing concepts of income and place of accrual are being observed to be inadequate.

2. International Tax Conflicts and Double Taxation

2.1 Introduction

In this chapter, the issues of double taxation and tax conflicts which arise in the world of international taxation are elaborated.

2.1.1 Double Taxation

Globally countries follow three types of rules to tax income of a person – source-based rule, residence based rule and citizenship based rule. Source based rule allows countries to tax income which has economic root in the country. Under residence-based rule countries tax global income of their residents. Under citizenship-based rule the global income of a citizen is subjected to taxation in a country. The first two rules are more prevalent, while citizenship based taxation has been adopted by a very few countries. Double taxation is the result of taxation of same income in the hands of same person for the same period due to overlap of taxing jurisdiction or taxation of same income in the hands of two persons for the same period due to transfer pricing issues. The former is known as juridical double taxation while latter is known as economic double taxation. The juridical double taxation arises due to overlapping of jurisdictions to tax. It, normally, arises when one country follows source-rule and other follows residence-rule of taxation. The following example shows how the tax laws of two countries are triggered.

- Mr. A, an Indian businessman carrying on his proprietary business of trading of goods has set up a branch in United Kingdom (UK) to carry on trading activities.

- He has made some profits from such trading activities.
- This branch of Mr. A carrying on economic activities in UK will trigger provisions of Income Tax law in UK being the source country and India on account of Mr. A being resident in India. This leads to juridical double taxation.
- Since India has signed a tax treaty with UK, he would be eligible for relief from double taxation as per relevant provisions of the Income Tax Act, 1961 read with the applicable treaty provisions.

Tax policy and law is framed and put to effect by each country after considering various factors which have an influence on the functioning of a country.

The following illustration⁸ shows the difference in the system of personal taxation in India and the UK.

➤ Progressive Tax Rates in India for Assessment Year 2023-24

(For the taxpayer not opting to be taxed under new optional regime under section 115BAC)

Assessee other than senior citizens

Income	Tax Rate
Up to 2,50,000	NIL
From 2,50,001 to 5,00,000	5%
From 5,00,001 to 10,00,000	20%
Above 10,00,000	30%

Assessee – Senior Citizens up to 79 years of age

Income	Tax Rate
Up to 3,00,000	NIL
From 3,00,001 to 5,00,000	5%
From 5,00,001 to 10,00,000	20%
Above 10,00,000	30%

Assessee – Senior Citizens on and from 80 years of age

Income	Tax Rate
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⁸ The same is merely an illustration and it is subject to modifications in the law

Up to 5,00,000	NIL
From 5,00,001 to 10,00,000	20%
Above 10,00,000	30%

➤ **Progressive Tax Rates in India for Assessment Year 2023-24**

(For the taxpayer opting to be taxed under new regime and not claiming deductions and exemptions)

Income	Tax Rate
Up to 2,50,000	NIL
From 2,50,001 to 5,00,000	5%
From 5,00,001 to 7,50,000	10%
From 7,50,001 to 10,00,000	15%
From 10,00,001 to 12,50,000	20%
From 12,50,001 to 15,00,000	25%
Above 15,00,000	30%

➤ **Progressive tax rates in UK(Scotland)⁹ for the period 6th April 2023 to 5th April, 2024**

Income	Tax Rate
Up to 12,570 ¹⁰ GBP ¹¹	NIL
From 12,571 GBP to 50,270 GBP	20%
From 50,271 GBP to 1,25,140 GBP	40%
Above 1,25,140 GBP	45%

Similarly, one will observe differences in tax laws of one Country vis-à-vis the other Country.

The classic example for the cause of double taxation is due to following *the “Residence rule and / or Source rule of taxation”*.

Some countries like India and USA levy tax on both, source rule and residence rule. A resident of India earning income from say USA would be taxed in both USA and in India. Tax would be levied in USA on account of source-based taxation and tax would be leviable in India on account of the connecting factor being residence. USA levies taxation on the basis of citizenship, also.

2.1.2 Interpretation of Tax Treaties

At times conflicts arise in international taxation on account of differences in interpretation of tax

⁹<https://www.gov.uk/income-tax-rates>

¹⁰ 12,500 GBP is the maximum amount not chargeable to tax in UK. The tax rates in UK is subject to various other provisions of the tax laws in UK which have not been discussed

¹¹ GBP refers to Great Britain Pounds

treaties by the tax authorities and the taxpayers and differences in interpretation of provisions of the domestic laws of the respective countries.

- **Impact of Judge Made Law**

Further, the “Judge Made Law” also has an impact in its unique way since the interpretation of provision(s) of the law by Courts eventually becomes the law of the land.

- **Indian Scenario**

In various cases, there has been a situation where a particular High Court renders decision in favour of the taxpayer while another High Court rules a decision involving similar question of law in favour of revenue. This matter then needs to be decided by a higher Court i.e. the Supreme/Apex Court to settle the issue. Similarly, there are various other issues which have an impact in some way or the other which changes the way in which law in a particular country functions. Let us elaborate further in the subsequent paragraphs of this topic.

2.2 Reason for Conflicts in International Taxation

There may be a situation in Country X where the outcome of the Court rulings and / or the manner in which the law functions may be different. Conflicts in the world of international taxation arise when a particular cross-border economic activity interacts with the tax laws of the respective two or more countries.

On account of gaps in interpretation of the laws in the respective countries, the taxpayers may have to face the brunt of being taxed more than once. Such differences in interpretation could also result in double non-taxation.

2.2.1 Classification Conflict

Country X may treat a particular income as royalty/fees for technical services, whereas its counterpart, say Country Y, may tax it as business profits.

2.2.2 Taxability of an entity

Country X (say USA) may consider partnership firm as a transparent entity whereby its partners are taxed and not the firm, whereas its counterpart Country Y (India) considers a partnership entity as an opaque entity and tax is levied on the firm whereas its partners are exempt from taxation.

2.2.3 Conflicts due to difference in tax system

Countries like Hong Kong and Singapore follow territorial tax system wherein tax is levied only on income from a source inside the country. In some circumstances, Singapore also levies tax on income which is received in another country.

2.2.4 Tax credit and Dispute Resolution

It is the use of tax treaties and various other provisions specifically enacted under the law which enables the taxpayer to claim relief from double taxation. Further, these treaties and other

provisions of the law also help to settle disputes between the Contracting States and make an attempt to bring clarity in law in case of ambiguity, if any.

2.3 Mutual Agreement Procedure (MAP)

The concept of MAP refers to a mechanism under which tax authorities of two countries try to settle a tax dispute acceptable to them as well as the taxpayer. It may be considered as an Alternative Dispute Resolution mechanism. The biggest plus point with this is that even disputes which are likely to arise may be taken up for resolution. It is part of UN (United Nation), the OECD and US tax treaty models and is integral part of tax treaties based on these models.¹²

A tax dispute may arise on account of various factors such as (i) difference in characterizing the income as per the treaty and as per the domestic laws of the Country of residence (ii) triangular taxation cases (iii) determining residential status of a person etc. Through MAP, taxpayers may approach the competent authorities for various issues which includes but not limited to a case where action of one or both of the Contracting State results in taxation which is not in accordance with the tax treaty.

Article 25 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on the Mutual Agreement Procedure is reproduced as under

- 1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of either Contracting State. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.*
- 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.*
- 3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.*
- 4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding*

¹² For detailed discussion on MAP refer to Module C

paragraphs.

5. Where,

- (a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
- (b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities,

any unresolved issues arising from the case shall be submitted to arbitration if the person so requests in writing. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

- Not all countries adopt the arbitration provisions contained in the OECD Model in their bilateral agreements for the reason that it impinges on their sovereignty to impose taxes. India is an example.

2.4 Some Conflicts in International Taxation

2.4.1 Triangular taxation

This is a typical case where a particular entity, resident of Country A interacts with the tax laws of its home Country (Country A) and tax laws of Country B and Country C.

Case I

- A Ltd of Country A has set up a branch in Country B.
- The said branch carries on economic transactions which give rise to taxable income in Country B under Article 7 of the tax treaty between Country A and Country B.
- Relief from double taxation is available to A Ltd based upon the tax treaty provisions of the two Countries.

Case II

- Now, taking the above situation forward, branch of A Ltd in Country B is considered as a non-resident as per the tax laws of Country B.

— The said branch had some transactions with C Ltd, a company resident of Country C.

- **Issues under consideration**

- (a) Where is the income of the branch taxable, Country A, B and / or C?
- (b) How will the branch avail of credit for taxes paid in Country C?
- (c) Where would the tax credit paid be available?
- (d) Can a non-resident of Country B avail of tax treaty benefits of the tax treaty between Country B and Country C?

- **Possible solutions**

Alternative I – Exemption in Country of Residence

All the three countries may like to tax A Ltd. for protecting their tax base. However, in doing so, A Ltd. would be adversely affected and it may not be good for the growth and development of global trade and commerce.

The solution provided below is without prejudice to the rights of any country to levy tax on its subjects. Taxation is a delicate issue since it is a major source of revenue for a Government which enables to plan the expenditure for the people of the nation as a whole. Tax policies are framed by a Government after having regard to the state of the economy of the country.

Country C

Considering the fact that Country C is a source country, Country C may levy tax on the income at lower rates and the collection of tax may be based on withholding basis.

Country B

- (i) Considering the force of attraction rule, the income of branch of A Ltd. may be taxed by Country B as per provisions of the domestic law which may levy tax on the branch of the non-residents.
- (ii) Further, since Country B (place of business for branch of A Ltd) is exercising its right to tax the economic transaction carried on by a non-resident (A Ltd) of Country B with another non-resident (C Ltd) of Country B, the source of which is Country C (third country), ideally, Country B should provide for credit for taxes paid in Country C to the branch of A Ltd. One may argue that as per the tax treaty between Country B and Country C, A Ltd. a non-resident of either of the Contracting State is not entitled to tax treaty benefits between Country B and Country C. The possible solution could be to entitle the permanent establishment for the tax treaty relief.
- (iii) Considering the above contention, the treaty between Country B and Country C may be suitably modified to include such branch in the definition of non-resident for the purpose of availing of tax benefits which is otherwise available to a resident. Also, considering the non-discrimination clause, one may say that by taxing the transaction of two non-residents without providing relief of double taxation, Country B is acting in a manner

prejudicial to global trade and commerce and such actions will adversely affect the business opportunities available to taxpayers.

Country A

- (i) The branch profits may be subject to tax in the home country. In such cases, considering the fact that income of branch is already taxed twice i.e. Country B and Country C, Country A may waive its right to tax such income involving triangular cases.
- (ii) The solution provided in (i) above is without prejudice to the levy of tax of such other income which does not involve triangular case of taxation.

Alternative II – Credit in Country of branch and Country of residence

From the alternative 1, if Country A does not waive its right to tax A Ltd., the branch of A Ltd., by invoking non-discrimination clause, shall be entitled for credit for taxes paid in Country C (State C) against the tax payable in Country B (State B). The tax paid in State B would then be available as credit in Country A (State A).

Particulars	State A (Tax rate 40%)	State B (Tax rate 30%)	State C (Tax rate 20%)	Remarks
Income	200	100	50	— Income in Country B includes income from Country C — Income in Country A includes income from Country B
Tax payable	80	30	10	
Less - Tax credit	20	10	-	
Net tax payable	60	20	10	

Alternative III – Exemption in Country of branch

Without prejudice to the right of Country B to levy tax on the branch profits, the income from Country C which may be taxable in the three jurisdictions viz. Country A, B and C, shall not be taxed in Country B for the following reasons:-

- (i) Taxing the same income thrice with the risk of non-availability of tax credit is a hindrance to development of global trade and commerce.
- (ii) The income is earned by a non-resident from another non-resident and a presence of A Ltd (taxpayer) in Country B should not act as a deterrent to carry on business activities irrespective of the fact that A Ltd. is a resident or otherwise of Country B.
- (iii) Taxpayers, considering the brunt of triangular taxation may start using tax evasion and/or

avoidance techniques¹³ which may deprive Country A, B and/or Country C from its fair share of revenue which could otherwise be earned by negotiating such peculiar cases.

Further, the tax treaty of Country A and Country C shall govern the provisions which enable relief from double taxation in such unique cases.

2.4.2 Timing mismatch

Timing mismatch refers to a situation where the taxation laws of the two or more different economies exercises its right to tax a particular economic transaction. However, the period of taxing the said transaction would be different.

For example

- Calendar year taxation – US system [Year 2015]
- Previous year taxation – Indian system [Previous year 2015-16]

Branch of US based company situated in India is taxed in India as per the previous year say. April 2015 to March 2016 whereas the company in US would be taxed as per the Calendar year 2015. The Company would be required to file its tax returns and pay the tax due in the month of April 2016 on its global income including the branch profits.

Alternative I

In such cases, one may take a view that the profits of the branch which are taxed in India on previous year basis could be ascertained only after the end of the previous year 2015-16 and therefore, US shall tax the income only in Calendar year 2016.

Alternative II

US Company should ascertain profits of its Indian branch on a Calendar year basis (which normally companies follow for the purpose of consolidation) and claim pro-rata tax credit in USA for taxes paid in India.

Alternative III

Mutual Agreement Procedure (MAP) - The other way which taxpayer can adopt is by approaching the tax authorities of the two countries viz. US and India to arrive at a solution which settles the issue and saves on the cost of litigation.

Timing mismatch and triangular taxation

The timing difference conflict would further be complicated in case of a triangular tax situation. However, assuming that the solution (without considering timing issues) provided is a most suitable solution, it would be a huge challenge to reconcile the timing differences to tax such income as per the tax year of a particular Country.

2.4.3 Difference in characterization of income

Royalty vis-à-vis Business Income

¹³ For more details on tax evasion v/s. tax avoidance, refer anti-tax avoidance measures.

There are instances where a particular income is considered as a royalty receipt in the Country of Source whereas, the same may be considered as business income in the Country of residence. Such a situation is not a problem. The problem arises when there is denial of credit for taxes paid in Country of Source in spite of qualifying for such benefits of tax treaty between the two Contracting States.

Let us consider an example for a better understanding of the above issue :

- Mr. Shetty, an Indian assessee running a business of restaurants and bar, has a very strong goodwill in India.
- The Shetty group wants to expand its operations globally.
- To do this, it has set up subsidiaries outside India under the same brand name with an intention to also provide franchise services.
- After developing goodwill globally, it starts providing franchise services to earn more revenue and enable to exploit the benefits from its brand name.
- Mr. Shetty is now in receipt of franchise income globally.
- The franchise receipts fall within the definition of “royalty” under the tax laws of the other countries (source country).
- Such royalty payments are subject to tax in the Country of Source.
- Now, while filing the return of income in India, Mr. Shetty has characterized the same as business income and has also claimed certain expenses which were incurred in relation to such brand name and also claimed credit for taxes paid in the Country of Source.
- **Issue under consideration before the tax department in India**
 - (a) Under the Income-tax provisions in India, the income is characterized as business income.
 - (b) The Income-tax department may deny tax credit on the following grounds:-
 - (i) Business income under Article 7 of the tax treaties provides that the business income shall be taxable in the other State (source country) only if there is a permanent establishment in that State.
 - (ii) Franchise receipts earned without any permanent establishment by Mr. Shetty are not taxable in Source country.
 - (iii) Merely because income is characterized as royalty and tax has been paid does not mean that the Country of Resident is bound to provide relief for taxes paid.

Under the circumstances, Mr. Shetty can argue that since the royalty income is taxed by the state of source in accordance with the provisions of tax treaty, he is entitled to credit of withholding tax. Much depends upon the actual provisions of the relevant tax treaty. But there are bright chances that Mr. Shetty would get the tax credit and if he fails to convince the

assessing officer, he can invoke provisions of the Mutual Agreement Procedure and get relief.

2.4.4 Determining residential status as per tax treaty

The two-taxation system normally being followed are (i) Source based taxation and (ii) Residence based taxation. The Country which follows the comprehensive tax system, taxes its residents based on global income. One exception to the above tax system is USA. USA levies taxes based on citizenship also and therefore US citizen are taxed in USA on their global income irrespective of their residential status.

However, as we are aware that tax laws of different countries have different rules of taxation. On account of the fact that there is a difference in the residence rule, there is a possibility for a person to be considered as a resident of the two countries. Therefore, both countries may exercise right to levy tax on the global income of the resident. Article 4 of the OECD model tax convention provides for methods which enables determination of the residential status of a person, or for breaking the tie in the case of dual residence.

Article 4 of the Model OECD tax convention¹⁴ provides that:

1. *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, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognized pension fund of that State. This term, however, 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.***
2. *Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:*
 - (a) *he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);*
 - (b) *if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;*
 - (c) *if he has an habitual abode in both States or in neither of them, **he shall be deemed to be a resident only of the State of which he is a national;***
 - (d) *if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.*
3. ***Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the***

¹⁴ MODEL TAX CONVENTION (CONDENSED VERSION) © 2017 – page no. 30

Contracting States shall endeavor to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

The model convention itself has provided various methods based upon which the conflict of determining residential status could be resolved. The following ways have been provided to resolve the issue of residential status under the model tax convention -

➤ **Paragraph 1:- (general definition)**

It qualifies those people who are liable to tax by reason of domicile, residence, place of management or any other criterion of similar nature. The liable to tax condition has to be due to any of the connecting factors listed and not because income is sourced in that State.

➤ **Paragraph 2- (Tie breaker rule)**

Under the tie breaker rule itself, various other methods are provided. For instance, paragraph 2(a) and paragraph 2(b) determine residential status based upon center of vital interests and place of habitual abode. Paragraph 2(c) determines a person as resident of one of the Contracting State on the basis of nationality and / or citizenship. Paragraph 2(d) provides for settlement of disputes by adopting the MAP mechanism.

➤ **Paragraph 3:- Place of Effective Management**

Paragraph 3 provides for taxpayers other than individuals to be considered as resident of one of the Contracting State on the basis of mutual agreement between the competent authorities of the Contracting states having regard to the Place of Effective Management of the taxpayer¹⁵.

➤ **India-US DTAA**

Paragraph 3 of India-USA DTAA is reproduced as under-

“Where, by reason of paragraph 1, a company is a resident of both Contracting States, such company shall be considered to be outside the scope of this Convention except for purposes of paragraph 2 of article 10 (Dividends), article 26 (Non-discrimination), article 27 (Mutual Agreement Procedure), article 28 (Exchange of information and administrative assistance) and article 30 (Entry into force)”.(Emphasis supplied)

Therefore, from the above, it can be seen that dual-resident companies would not be entitled to tax treaty benefits which are otherwise available.

¹⁵ India, by amending section 6(3) of the Income Tax Act, 1961 has provided that a company will be considered as a resident of India for tax purposes either on the basis of (i) place of incorporation and (ii) place of effective management.

2.5 Double taxation on account of Transfer pricing adjustments

Transfer pricing refers to pricing of goods and services transacted between associated and/ or controlled and/ or related legal entities within a group. For example, if a parent company provides managerial services to a subsidiary company, the price of the services charged by the parent is the transfer price.

As the transactions happen within the group the price determination may be influenced by the common interest and thereby may differ from the free market driven pricing. In the global business environment, multinational groups possess the ability to shift their profits in a manner where high profits are parked in a low tax jurisdiction and no profits and/ or very low profits are allocated to a jurisdiction where the tax rates are high. Transfer pricing deprives a country of its fair share of revenue of taxes and therefore, as a measure to protect the tax base of the jurisdiction, transfer pricing rules are introduced in the tax laws.

Example of a Transfer pricing adjustment

A Ltd (parent company), a foreign company sells goods to B Ltd (subsidiary company), an Indian resident company at INR100/-

Similar goods, in comparable circumstances are sold by the parent company to another unrelated party at INR 90/- i.e. in an arm's length transaction.

In India, under the Transfer pricing assessments, there will be an addition of INR 10/- to the total income of B Ltd on account of Transfer pricing not being at arm's length price.

Implications

Income of INR 10/- at the group level would be taxed twice. **Firstly**, in the country of A Ltd and **secondly**, in India in the transfer pricing assessments of B Ltd due to enhancement of profits on account of lower of cost of purchase.

Some treaties have provisions for corresponding adjustment to be given by a State in respect of profits that are taxed in the other State due to a transfer pricing adjustment. Also, in order to resolve the issues related to transfer pricing, Advance Pricing Agreement (APA) mechanism and Safe Harbor Rules have been introduced in several jurisdictions to settle transfer pricing issues and litigations.

2.6 Base Erosion Profit Shifting¹⁶

The Base Erosion and Profit Shifting ('BEPS') project was initiated by OECD in order to eradicate the double non-taxation and address the gaps and mismatches in tax rules resulting in artificial shifting of profits. The work was carried out in the OECD/G20 BEPS Project, whose outputs were released by way of 15 Action Plans in October 2015. The implementation of all the proposals of the BEPS project required changes to be carried out in the model tax conventions

¹⁶ This is discussed in greater details elsewhere in this book

as well as several bilateral tax treaties. This would have necessitated renegotiating approximately more than 3000 bilateral tax treaties¹⁷ the implementation of which would have taken several years. Thus, to avoid this situation, it was decided to develop an instrument to modify existing tax treaties in a synchronized and efficient manner as included in BEPS Action 15 Report.

The work began in May 2015 with the aim of finalizing and opening it for signature on 31 December, 2016. On 7 June, 2017, 68 countries signed the “*Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting*” (hereinafter referred to as MLI) in Paris.

2.7 Conclusion

Globalization to a considerable extent has made the planet earth a single integrated market where cross-border economic transactions are frequent. In such a scenario, issues including tax aspects have become very important to understand the trend which is shaping the business environment. Issues in international taxation (including but not limited to claiming credit for tax paid in other country, income characterization, etc.) and understanding the gravity of the adverse situation which may arise due to differences in interpretation by tax authorities also require a careful consideration before taking any business / commercial decision.

3. Double Tax Treaties

Part I - Double Tax Avoidance Agreements – An Overview

3.1 Introduction

Every nation has sovereign right to tax its residents/nationals on their worldwide incomes. As a result, the income of a person can get taxed in both countries i.e. in the home country (country of his residence) as well the host country (country where income is generated) . There may be economic double taxation due to transfer pricing adjustment. In such an environment, the benefits of international trade and competitive cost advantages would be lost. Double taxation is harmful for movement of capital, technology transfer, commerce, trade, and of course, people. In order to prevent the injury caused to international trade and commerce, Article 51 of the Indian Constitution has inter-alia set out some directive principles which must be followed by the State. It has been provided that-

"The State shall endeavour to -

- (a) *promote international peace and security;*
- (b) *maintain just and equitable relations between nations;*

¹⁷ Explanatory statement to the multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting

- (c) *foster respect for international law and treaty obligations in the dealings of organised people with one another;*
- (d) *encourage settlement of international disputes by arbitration.*

(Emphasis supplied)

It is pertinent to note that entries 10 and 14 of list I of the seventh schedule confer the power on Parliament to legislate the treaties with foreign countries. Further, this power of Parliament has been delegated to the Central Government vide section 90 and 90A of the Income-tax Act, 1961 to issue notifications to make necessary provisions to implement double tax avoidance agreements.

Article 2 of Vienna Convention on Law of Treaties, 1969 defines Treaty as –

“Treaty” means an international **agreement** concluded between States **in written form** and **governed by international law**, whether embodied in a **single instrument or in two or more related instruments** and whatever its particular designation.

In home country, tax is an obligation, while in the host country, tax is a cost. Therefore, there is need to achieve tax efficiency. Tax Treaties come into play to mitigate hardship caused by subjecting the same income to double taxation.

Tax treaties attempt to eliminate double taxation and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned states on a rational basis though it is to be conceded that tax treaties do not always succeed in eliminating double taxation.

DTAAs are also known as AADTC (Agreements for Avoidance of Double Taxation), Tax Treaty or as DTCs (Double Tax Conventions). However, use of the term DTCs is very common worldwide. These terms are used interchangeably.

3.2 Historical Development of DTAA

- 1st treaty was signed by Austria & Prussia 21st June 1899 - World war.
- US were very aggressive in giving Foreign Tax Credit in the early Twentieth (20th) Century.
- Foreign tax credit granted by Netherlands & Belgium to their colonies.
- Problem became acute in 1920 when group investments started by capital exporting countries in the developing countries.
- Setting up the International Chamber of Commerce.
- 1921 - London Congress – Adoption of the general principles.
- A Committee drafted resolution in 1922 which was revised in 1924.
- After 1st World war, it was the League of Nations who took up this subject.
- In 1925, a report on “Double Taxation and Fiscal Evasion” was submitted.

- In 1928, the first four 'Model Conventions' for the prevention of Double Taxation were developed. It was at this stage where permanent establishment as a taxing threshold in source states came into existence.
- In 1943, Mexico Model of Tax Convention had emerged.
- In the year 1946, London Model Convention was drafted to encourage capital flow from Industrial countries to developing countries by limiting taxation to the country where income was ultimately received.
- In the year 1956, OECD was set up wherein work had begun on DTAA Model Tax Convention.
- Early bilateral tax treaties – Germany.
- The League of Nations had also come up with various models from the period from 1922 to 1946.
- OEEC [Organisation for European Economic Co-operation] + OECD [Organisation for Economic Co-operation and Development] :
- 1956 - Study International Double Taxation
- 1963 - Draft Model Tax Convention
- 1977 Model
- 1992 Model
- Updates 1994, 1995, 1997, 2000, 2002, 2003, 2005, 2008, July 2010, July 2014 and November 2017.
- UN Manual 1979, Model 1980 (Updated 2001) and UN Model 2011, 2017 and 2021 updates of the UN Model Double Taxation Convention between Developed and Developing Countries.

3.3 Importance of DTAA's and Some Definitions

The committee on Fiscal Affairs of the OECD (Organisation for Economic Co-operation and Development) in its introduction to the OECD Model Convention has defined "International juridical double taxation". According to the said committee "International juridical double taxation" can be generally defined as "the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology, and persons, are so well known that it is hardly needed to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries".

The need to eliminate double taxation, implement effective avoidance measures etc. is very well known. Understanding the importance of such requirements, the UN has specifically provided

the following in its commentary to model tax convention 2011 -

“The growth of investment flows between countries depends to a large extent on the prevailing investment climate. The prevention or elimination of international double taxation in respect of the same income - the effects of which are harmful to the exchange of goods and services and to the movement of capital and persons, constitutes a significant component of such a climate.

Broadly, the general objectives of bilateral tax treaties therefore include the protection of taxpayers against double taxation with a view to improving the flow of international trade and investment and the transfer of technology. They also aim to prevent certain types of discrimination as between foreign investors and local taxpayers, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can confidently be carried on. With this background, tax treaties should contribute to the furtherance of the development aims of developing countries. In addition, the treaties seek to improve cooperation between taxing authorities in carrying out their functions, including by the exchange of information with a view to preventing avoidance or evasion of taxes and by assistance in the collection of taxes”. (Emphasis supplied)

DTAA can be defined as an “international agreement between two sovereign states reaching an understanding as to how their residents will be taxed in respect of cross border transactions in order to avoid double taxation on the same income”.

In yet another way DTAA can be defined as “an agreement of compromise between two contracting states whereby each State agrees to give up something in consideration of the other State giving up something in its favour”.

Objectives of DTAA

From the above definition, it is clear that the primary objectives of DTAA are to avoid double taxation and sharing of revenue between States through negotiations and compromise. Besides, it can effectively achieve following additional objectives as spelt out in the UN Model.

- to protect taxpayers against double taxation
- to encourage free flow of international trade and capital
- to encourage transfer of technology
- to prevent discrimination between taxpayers
- to provide a reasonable element of legal and fiscal certainty to the investors and businessmen.
- to arrive at an acceptable basis to share tax revenues between the two states.

Section 90(1) of the Act, provides that the Government of India may enter into DTAA with any foreign country or specified territory outside India for the following objectives -

“(a) for the granting of relief in respect of—

- (i) *income on which have been paid both income-tax under this Act and income-tax in that country or specified territory, as the case may be, or*
- (ii) *income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory, as the case may be, to promote mutual economic relations, trade and investment, or*
- (b) *for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory, or*
- (c) *for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory, as the case may be, or investigation of cases of such evasion or avoidance, or*
- (d) *for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory, as the case may be,*

and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement”.

Further, section 90A(1) provides that the specified association in India may enter into an agreement with any specified association in the specified territory outside India for the above purposes and the Central Government may notify the same in the Official Gazette to adopt and implement such agreement.

3.4 Indian Tax Laws and Tax Treaties

3.4.1 Power to Central Government

The Government of India may enter into Double Taxation Agreement with any foreign country or a specified territory under section 90(1) of the Income Tax Act, 1961 (“the Act”) and is empowered to, by notification in the Official Gazette, make such provisions as may be necessary for implementing the said agreement.

3.4.2 Unilateral relief

Section 91 of the Act provides for unilateral tax relief to a resident in India in the case of doubly taxed income, where income tax is paid in a country with which India does not have a tax treaty.

3.4.3 Treaty and Domestic law

When a double tax avoidance agreement is notified by the Central Government and implemented following the procedure laid down in section 90(1), the provisions of such an agreement, with respect to cases to which where they apply, would operate even if inconsistent

with the provisions of the Income-tax Act.¹⁸

In 1991, by an amendment to section 90 of the Act, that is, by insertion of sub section (2), the law now provides that the provisions of the Act shall apply to the extent they are more beneficial to the assessee to whom a tax treaty applies.

However, sub-section (2A) to section 90 which was inserted by the Finance Act, 2013 provides that provisions of chapter X-A dealing with General Anti-Avoidance Rules (commonly known as 'GAAR') shall apply to the assessee even if such provisions are not beneficial to him. The GAAR provisions are effective from assessment year 2018-19 onwards (i.e. financial year 2017-18 onwards). The necessary provisions for application of GAAR have been provided in Chapter X-A of the Act read with Rules 10U to 10UC of the Income-tax Rules, 1962.

3.4.4 Choice of Beneficial Provisions under DTAA/Tax Laws

Under the amended provision, the assessee has the best of both the worlds. He can take recourse to the provisions of the DTAA and reap benefits of Tax treaties. In case there is a conflict between the provisions of the domestic law vis-à-vis the beneficial provisions Tax treaty, if it be the case, provisions of the latter shall prevail, if the taxpayer opts for that. This is the position in most of the countries.

The added benefit of the amended section 90 of the Act is that the assessee can opt for the benefit of the Indian the Act if its provisions are more beneficial compared to the provisions of a Tax treaty, except where GAAR provisions are invoked.

The courts have held that, in general, if the Act itself does not impose any liability to tax under it, the question of resorting to the DTAA would not arise. A DTAA by itself cannot create a tax liability.

3.5 Advantages of Tax Treaties

Tax treaties clearly lay down the provisions for taxing of income under various heads. There is less room for ambiguity. For instance, business profits are taxable in the host country only if there is a "*Permanent Establishment*" as defined in the Treaty.

Income is not taxed solely on the grounds of "*business connection*" as it may happen under the all-pervading section 9 (1)(i) of the Act.

Similarly, income from Royalties, Fees for Technical Services, Dividend, Interest and Capital Gains are taxed in the source country at concessional rates subject to the relevant conditions prescribed under the respective Articles of the DTAA. Further, to avail the beneficial provisions of DTAA, it has been specifically provided under section 90(4) of Act, that the resident of the contracting state shall provide the tax residency certificate of the said contracting state.

¹⁸ Union of India v Azadi Bachao Andolan (2003) 132 Taxman 373 (SC)

3.6 Treaty Models

There are different models developed over a period of time based on which treaties are drafted and negotiated between two nations. These models assist in maintaining uniformity in the format of tax treaties. They also serve as checklist to the two negotiating countries.

OECD Model, UN Model, the U.S. Model and the Andean Model are a few of such models. Of these, the first three are the most prominent and often used models. However, a final double taxation avoidance agreement could be a combination of different models.

3.6.1. OECD Model

The emergence of present form of OECD Model Convention can be traced back to 1927, when the Fiscal Committee of the League of Nations prepared the first draft of Model Form applicable to all countries. In 1946 the model convention was published in Geneva by the Fiscal Committee of U.N. Social & Economic Council and later by the Organization for European Economic Co-operation (O.E.E.C) in 1963. However, in 1961, the Organization for Economic Co-operation and Development (O.E.C.D) was established, with developed countries as its members, to succeed the O.E.E.C., and OECD approved the draft presented to the OEEC. In 1977, the final draft was prepared in the present form which has been revised several times; the latest being in the year 2017.

OECD Model is essentially a model treaty **between two developed nations**. This model advocates residence principle, that is to say, it lays emphasis on the right of state of residence to tax the income.

3.6.2. U.N. Model

In 1968, the United Nations set up an Adhoc Group of Experts from various developed and developing countries to prepare a draft model convention between developed and developing countries. In 1980, this Group finalized the UN Model Convention in its present form. It has further been revised a number of times, the recent ones being in the year 2017.

The UN Model is a compromise between the source principle and the residence principle. However, it gives more weight to the source principle as against the residence principle of the OECD Model. UN Model is designed to encourage flow of investments from the developed countries to developing countries. It takes into account sharing of tax-revenue with the country providing capital. Most of India's tax treaties are based on the UN Model.

3.6.3. US Model

The US Model is different from OECD and UN Models in many respects. For example, Indo-US treaty provides for Permanent Establishment Tax (Article 23) and Limitation on Benefits (Article-24), which are unique to this treaty as also provision for taxing Capital Gains (Article 13) as per the domestic law. Also, US Model does not have a Tax sparing Clause.

3.6.4. Andean Model – Distinguishing Features

It is a regional level model convention developed in 1971.

A group of lesser and medium developed Latin American countries have adopted this Model, namely, Bolivia, Columbia, Chile, Ecuador, Peru, and Venezuela.

It provides for almost exclusive taxation in source country except in cases of international traffic. PE concept is not adopted. This model is not used by other countries.

3.7 General Features of DTAA

3.7.1 Types of DTAA

DTAAs can be of two types, limited or comprehensive. Limited DTAAs are those which are limited to certain types of incomes only e.g. DTAA between India and Pakistan is limited to shipping and aircraft profits only.

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time, a treaty also covers wealth tax, gift tax, surtax, etc.

3.7.2 Language used by Treaties.

Tax Treaties employ standard international language and standard terms. This is done in order to understand and interpret the same term in the same manner by both/all the countries that are party to a particular treaty. Language employed is technical and stereotyped. Some of the terms are explained below:

Contracting State	It means a country which enters into the Treaty
State of Residence	Country where a person resides
State of Source	Country where income arises
Enterprise of a Contracting State	Any taxable unit (including individuals) of a Contracting State
Permanent Establishment	A fixed place of business through which the business of an enterprise is carried on (usually a branch/project of a foreign company and in some cases wholly-owned subsidiaries and dependent agent as well).

One has to read the treaty as a whole in order to understand its provisions in their proper perspective.

3.7.3 Composition of a Comprehensive DTAA

DTAAs are also termed as conventions. They are signed between two sovereign states. They are exhaustive and self-contained in nature. The conventions are divided in the following broad heads -

MODEL DOUBLE TAXATION CONVENTION – BROAD HEADS

Article	Heading	Content
1	Scope of the Convention	To whom applicable
2	Taxes Covered	Specific taxes covered
3	General Definitions	Person, company enterprise, inter-national traffic, competent authority
4	Resident	'Resident' of a contracting state who can access treaty
5	Permanent Establishment (PE)	> What constitutes PE > What does not constitute PE
6	Income from Immovable Property	Immovable property and income there from
7	Business Profits	Determination and taxation of profits arising from business carried on through PE
8	Shipping, Inland Waterways, Transport and Air Transport	Place of deemed accrual of profits arising from activities and mode of taxation thereon
9	Associated Enterprises	Enterprises under common management and taxation of profits owing to close connection (other than transactions of arm's length nature)
10	Dividends	> Definition and taxation of dividends > Concessional rate of tax in certain situations;
11	Interest	> Definition and taxation of interest; > Concessional rate of tax in certain situations; > Taxation of interest paid in excess of reasonable rate, on account of special relationship;
12	Royalties	> Definition of royalties – what it includes and covers, and its taxation; > Treatment of excessive payment of royalties due to special relationship; > Country where taxable.
13	Capital Gains	> Definition – Taxation aspects; > Concessional rates / exemption from tax if any; > Country where taxable
14	Independent Personal Services	> Types of services covered

Article	Heading	Content
	[Note: OECD M.C has now deleted this clause]	> Country where taxable
15	Income from employment / Dependent Personal Services	> Definition > Country where taxable
16	Directors' Fees and Remuneration for Top Level Managerial Officials	> Definition > Mode and Country where taxable.
17	Income earned by Entertainers and Athletes	> Types of activities covered > Mode and Country where taxable.
18A/B	Pension and Social Security Payments	Country where taxable
19	Remuneration and Pensions in respect of Government Services	Type of remuneration, and country where taxable
20	Payment Received by Students and Apprentices	Taxation / Exemption of payments received by students and apprentices.
21	Other Income	Residual Article to cover income not covered under other 'Articles', mode of taxation and country where taxable
22	Capital (Tax on Wealth)	Definition – mode – and country where taxable
23 A/B	Methods of Elimination of double taxation	Exemption Method / Credit Method
24	Non-discrimination	(Equitable) Basis of taxing Nationals and Citizens of Foreign State
25	Mutual Agreement Procedure	> Where taxation is not as per provisions of the convention, a 'person' may present his case to Competent Authorities of respective states. > Procedure in such cases
26	Exchange of Information	> Competent Authorities to exchange information for carrying out the provisions of the convention. > Methodology.
27	Assistance in collection of taxes	Competent Authorities to settle the mode of application of this Article
28	Diplomatic missions and Consular corps (Officers)	Privileges of this category to remain unaffected
29	Territorial Extension	To include territory not included

Article	Heading	Content
		earlier; by following appropriate steps mutually and as allowed by the constitution.
30	Entry into Force	> Effective date from which convention comes into force; > Assessment year from which it comes into force.
31	Termination	Time – Notice period – Mode.

3.7.4 Group Analysis

Broadly, all these above Articles can be divided into six groups for the purpose of analysis -

(i) Scope Provisions

Article-1	Scope of the convention
Article-2	Taxes Covered
Article-30	Entry into Force
Article-31	Termination

Provisions contained in these Articles determine scope of persons, taxes, and time period covered by a treaty.

(ii) Definition Provisions

Article-3	General Definitions
Article-4	Residence
Article-5	Permanent Establishment

In addition, the terms immovable property, dividend, interest, royalties, fees for technical services etc., are separately defined in the respective Articles.

(iii) Substantive Provisions

Articles between 6 and 22

These Articles (excepting Article 9 Associated Enterprises) are applicable to particular categories of incomes, capital gains or capital and allocate tax jurisdictions between the two contracting states. They provide the distributive rules for allocating taxing rights to one or both the Contracting States.

(iv) Provisions for elimination of double taxation

Articles-23	Method of elimination of double taxation
Articles-25	Mutual Agreement Procedure

Both these Articles are very important as they deal with the central objective of the DTAA i.e. avoidance or elimination of double taxation.

(v) Anti-Avoidance Provisions

- Articles-9 Associated Enterprises
- Articles-26 Exchange of Information
- Article 29 Entitlement to Benefits

Article 29 was added by OECD Model Convention (2017 Update) after the Multilateral Instrument was signed by several countries in June 2017. The US Model also contains an additional Article titled “Limitation of Benefits”. These Articles are gaining importance day by day and used by the tax authorities to prevent treaty shopping or abuse of treaty benefits¹⁹.

(8) Miscellaneous Provisions

- Articles-24 Non-Discrimination
- Article- 27 Assistance in collection of Taxes
- Articles-28 Diplomats

The Article on Non Discrimination is used to ensure justice and fair tax treatment to the assessee of one of the contracting state by the other contracting states.

Articles-28 on Diplomats ensures that privileges of this category of persons remain unaffected.

Illustration – Allocation of taxing rights

Tax by country of residence only but the same being subject to tax condition	India Sweden DTAA – Article 13(5) which is further subject to Article 13(6)
Tax to be levied only source country	India Bangladesh DTAA – Article 7
Tax levied by both, country of residence and source	a. Subject to upper limit – Royalties, Fees for technical services, interest, dividends b. Unrestricted right to tax – PE of resident of other contracting state
Tax levied by country of effective management only	Article 8 – Shipping income

¹⁹Article 27A (Limitation of Benefits) inserted in India-Mauritius DTAA dated 10-8-2016, w.e.f. 1-4-2017.

3.8 Interpretation of Tax Treaties

One should refer to the commentaries on the OECD Model or the U.N. Model which offer clarifications on the Articles (clauses) contained in the Treaty. The judgments of Indian and foreign Courts would also throw light on certain aspects.

3.8.1. Commentaries

There are two commentaries available – one by OECD and the other by UN, based on their respective models. which are updated and revised from time to time. UN commentary was published in 1980 and has been revised from time to time. Though the UN Commentary largely refers to the OECD commentary, there are significant differences to take into account the interests of developing countries. One needs to refer to the commentaries for interpretation and application of various provision contained in a DTAA.

3.8.2. Importance of Commentaries

Where contracting states adopt the text of the Article as per OECD Model convention without any change, and if these countries happen to be OECD Countries, the OECD commentary is directly applicable. In case of a DTAA between developed and developing countries, normally UN model is followed. UN Model and UN Commentary both being largely based on OECD Model and Commentary respectively, OECD Commentary is also quite helpful in interpretation of treaties based on UN Model.

Commentaries are cited by many Counsels while arguing a particular point in a court of law. Courts in India do consider interpretation given by the Commentaries. In the case of *CIT V. Vishakhapatnam Port Trust 144 ITR 146 (A.P.)*, the High Court referred extensively to the OECD Commentary and decisions of Foreign Courts. The Supreme Court also referred to many foreign court decisions and various books by eminent authors in the case of *Union of Indian v/s Azadi Bachao Andolan (2003) 263ITR 706 (SC)*. The importance of commentaries has been highlighted by the Supreme Court of India in a recent case²⁰.

India is not a member of OECD. However, India is an observer country and therefore it does participate in the discussion on revision of Model Commentary. At many places, India has expressed its reservations, indicating disagreement or preference or right to follow different tax treatment or interpretation.

3.8.3. DTAAs and Vienna Convention

Double Tax treaties being international agreements, creation and their consequences are determined according to the rules contained in the Vienna Convention on the Law of Treaties of 23rd May 1969.

Article 31(1) of the Vienna Convention Provides that “A treaty shall be interpreted in good faith

²⁰ ENGINEERING ANALYSIS CENTRE OF EXCELLENCE PRIVATE LIMITED, CIVIL APPEAL NOS. 8733-8734 OF 2018 Dated March 02, 2021.

in accordance with the ordinary meaning to be given to terms of the treaty in their context and in the light of its object and purpose”.

One can refer to following Articles of Vienna Convention for detailed rules of interpreting an international treaty (including tax treaty) - Article 31 (General rule of interpretation); Article 32 (Supplementary means of interpretation) and Article 33 (Interpretation of treaties authenticated in two or more languages)

Article 31(2) and (3) of the Vienna Convention further clarifies that following items should be taken into account while interpreting a treaty:-

- Any agreement (entered into subsequent to the treaty or along with the treaty) or instrument related to the treaty preamble and annexure of the treaty;
- any relevant rules of international law applicable between the parties.

Article 26 of the Vienna Convention lays down the principle of “Pacta Sunt Servanda” (Latin for “agreements must be kept”) which provides that *“Every treaty in force is binding upon the parties to it and must be performed in good faith.”*

Andhra Pradesh High Court, in the case of M/s Sanofi Pasteur Holding SA vs Department of Revenue, Ministry of Finance, Government of India (2013) (354 ITR 316), also emphasized that treaties must be performed and interpreted by the countries in good faith.

In general, normally accepted international customs and practices need to be considered while applying and interpreting tax and non-tax treaties. A careful reading of Article 31 reveals that certain documents in addition to DTAA are very important in interpreting tax treaties.

3.8.4. Reliance on Documents in addition to DTAA

Correspondence between the countries during negotiation of the treaty, exchange of notes while signing the treaty, minutes of the meetings held for negotiations and protocol to the treaty are all relevant documents in understanding the treaty in its true intent and meaning. Many of the documents cited here are not publicly available; however, they may be relevant in the course of Mutual Agreement Procedure. Protocols annexed to many treaties are very useful. In case of Abdul Razak A. Mema’s²¹ case the Authority for Advance Rulings in India did call for records relating to the discussions between the Indian Revenue Authorities and their counterparts in UAE in order to determine the intentions of both Governments while including provisions relating to individuals in the India-UAE DTAA despite the fact that individuals are not taxed in UAE.

3.8.5. Protocol and Memorandum

Protocol is like a supplement to the treaty and is an integral part of a treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies specified issues. Sometimes, unintended omissions are rectified. The treaty with USA goes one step further by incorporating a Memorandum of Understanding concerning

²¹ [2005] 276 ITR 306 (AAR)

Royalties and Fees for Technical Services and explaining the provisions with illustrations. However, one more important objective of the Protocol is to give effect to the Most Favoured Nation (MFN) clause. The MFN clause has very wide implications in application of DTAA provisions which are discussed in the succeeding paragraph.

3.8.6. Most Favoured Nation (MFN) Clause

MFN clause is usually found in Protocols or Exchange of Notes to DTAA. The MFN clause under a trade agreement /DTAA allows a more beneficial treatment to a contracting state over and above the terms of the agreement as were entered between the sovereign states. As per this clause, a contracting state agrees to accord to the other contracting state a beneficial treatment, in line with the similar beneficial treatment which it has accorded to the other third states.

The objective of MFN clause is to provide impetus to free trade and promote non-discrimination in terms of trade or taxability of income. At present, this clause forms part of 14 treaties entered by India with other contracting states, out of which, 10 are with OECD member countries while 4 are with other countries.

Let us understand this with the help of an example which deals with lower rate of tax. The MFN clause in the protocol on DTAA with FRANCE reads as follows:

“In respect of articles 11 (Dividends), 12 (Interest) and 13 (Royalties, fees for technical services and payments for the use of equipment), if under any Convention, Agreement or Protocol signed after 1-9-1989, between India and a third State which is a member of the OECD, India limits its taxation at source on dividends, interest, royalties, fees for technical services or payments for the use of equipment to a rate lower or a scope more restricted than the rate of scope provided for in this Convention on the said items of income, the same rate or scope as provided for in that Convention, Agreement or Protocol on the said items income shall also apply under this Convention, with effect from the date on which the present Convention or the relevant Indian Convention, Agreement or Protocol enters into force, whichever enters into force later.”

The effect of the above clause can be worked out on the India-France DTAA as below:

	As per France Treaty w.e.f 1.4.1995	As per German Treaty w.e.f.1.4.1997	As per Sweden Treaty w.e.f. 1.4.1998
Interest	10%	10%	10%
Royalties/FTS	10%	10%	10%
Payments for Use of Equipment	10%	-- ²²	-- ²³

²²There is no such specific Article specifying payment for use of equipment. However, the definition of royalty is of wide import and also includes payments for the use of equipment

²³ There is no such specific Article specifying payment for use of or right to use industrial, commercial or scientific

The intention of MFN clause in tax treaties is:

- Granting of lower rate on specified income and/or;
- Restricting the scope of income and/or;
- Other benefit in terms of allowance of expenses in case of business income

MFN clause, as forming part of protocol, is an integral part of the tax treaty. Dr. Klaus Vogel in his Commentary on Double Tax Conventions²⁴ mentions that-

“.....As previously mentioned, (final) protocols and in some cases other completing documents are frequently attached to treaties. Such documents elaborate and complete the text of a treaty, sometimes even altering the text. Legally they are a part of the treaty, and their binding force is equal to that of the principal treaty text. When applying a tax treaty, therefore, it is necessary carefully to examine these additional documents”
(emphasis supplied)

Article 31(2) of the Vienna Convention also emphasizes that any agreement or instruments made or agreed between the parties which are supplementary to the main text of the treaty are important for the purpose of interpreting the treaty²⁵

There is plethora of judgments²⁶ which have considered this aspect and have laid down certain principles with respect to the protocol i.e. protocol is self-operational document, forms an integral part of the treaty. The provisions of the tax treaty are to be read with the protocol and are subject to the provisions contained in such protocol. It is iterated in many decisions that there is no need to issue a separate notification for implementing a protocol.

The issues regarding implementation of MFN clause which have been subject matter of litigation are: whether the MFN clause would be applicable where the third countries were not members of the OECD at the time of entry into force of their DTAA's and whether a separate notification was required to import such benefits into the DTAA's with the MFN Countries.

Recently, the Supreme Court in its ruling [*Assessing Officer v. M/s. Nestle SA. Civil Appeal No(s). 1420 of 2023, Decision dated 19 October 2023*] laid down that a separate notification, under section 90(1) of the Act, is mandatory to give effect to any DTAA or its protocol that effectively changes the existing provisions of the law. The SC's reasoning was that although the Union has exclusive power to enter into DTAA's, the Parliament has the exclusive power to give effect to such DTAA's by enacting them into law. Unless such effect is given, the DTAA's are not, by their own force, binding upon Indian nationals. The Parliament must step in when such

equipment.

²⁴ Extract of the Commentary by Klaus Vogel on Double Taxation Conventions, Fourth Edition, (2014), at paragraph 69 on pg 34

²⁵ Although India is not a signatory to the Vienna Convention, but a reference is made by the Indian Courts with respect to the rules of interpretation contained therein.

²⁶ *Steria India Ltd vs. CIT* (2016) (386 ITR 390) (Del HC), *DCIT vs. ITC Ltd.* (2002) (82 ITD 239) (Kol), *Sumitomo Corpn vs. DCIT* (2008) (114 ITD 61) (Del), *Poonawalla Aviation (P.) Ltd.* (2011) (343 ITR 202) (AAR), *Idea Cellular Ltd.* (2012) (383 ITR

DTAAs affect the rights of citizens or modify the law of India. No legislation is required only when citizens' rights are unaffected, or the law is not modified.

The SC further observed that unilateral orders and decrees passed by the governments of other countries cannot be relied upon to interpret DTAAs as the manner of assimilation of DTAAs in other countries is greatly different from the manner of assimilation in India, where legislative action is required. In India, the general practice is to give benefit of the MFN clause post the issuance of a separate notification under section 90. Such a practice cannot be undermined.

On the issue of whether the third country needs to be a member of the OECD at the time of its DTAA coming into force, the SC, in its ruling, clarified that the phrase "is a member" implies present significance, which means that the third country must be a member of the OECD when it enters into a DTAA with India, for the earlier DTAA beneficiary to be able to claim applicability of the MFN clause.

3.8.7. DTAAs are self-contained Agreements

DTAAs are to be interpreted as self-contained agreements having in-built safeguards. It means that the scope or applicability of the treaty cannot be enlarged by assigning meaning which is contrary to the literal provisions.

The Madras High court in the case of CIT v Vr. S.R.M. Firm [1994] 208 ITR 400 held that tax treaties are considered to be "*mini legislation containing themselves all the relevant aspects or features which are at variance with the general taxation laws of the respective countries.*"

3.8.8. Meaning of Terms not defined in the Treaty

If a particular term is not defined in the treaty, its meaning can be ascertained with reference to the domestic tax laws of the source state. If it is not defined in the domestic tax laws of the source state, then the term would be interpreted as per the general law of the Source State.

Section 90(3) of the Act provides that any term used but not defined in the Act or in DTAA shall have the same meaning as assigned to it in the notification issued by the Central Government in this behalf, unless the context requires otherwise and is not inconsistent with the provisions of the Act or the relevant DTAA.

Explanation 3 to section 90 clarifies that where any term is defined by the Government Notification, it shall be deemed to have such meaning assigned from the date on which the relevant DTAA comes into force (in respect of which such term is notified).

Finance Act, 2017 has inserted Explanation 4 to section 90 of the Act which clarifies that where any term used in a DTAA is defined under the said DTAA, the said term shall have the same meaning as assigned to it in the DTAA; and where the term is not defined in the said DTAA, 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."

3.8.9. Approaches in Interpretation of Terms — Static v/s Ambulatory

When a treaty refers to the provision of the domestic laws of a contracting state for assigning

meaning to a particular term, and subsequently the domestic law is changed, then the question arises for assigning meaning to that term: Whether the treaty intended to assign the meaning which was prevailing in the domestic law of the contracting state at the date of signing the treaty (a static interpretation) or the meaning on the date of application of the treaty (an ambulatory interpretation)?

Delhi High Court in the case of *Shin Satellite Public Co. Ltd.* [ITA 500/2012] has held that “*No amendment to the Act, whether retrospective or prospective can be read in a manner so as to extend in operation to the terms of an international treaty.*”

An ambulatory interpretation is now explicitly called for by the OECD model convention commentary 2017 when the context does not require otherwise. However, an ambulatory approach cannot be applied where there is radical amendment in the domestic law that changes substance of the term.

3.9 How to Access a Treaty?

In order to make use of a DTAA, a person should be a resident of one of the contracting states. This concept is elaborated hereunder –

3.9.1 Person meaning

The term ‘person’ is defined in Article 3(1) of the OECD Model to include an individual, a company and any other body of persons. The definition of the term is not exhaustive and is required to be used in a very wide sense. India’s tax treaties define the term to include “*an individual, a company, a body of persons and any other entity which is treated as a taxable unit under the taxation laws in force in the respective Contracting States*”.

The reference to the taxable unit under the tax laws is because only a person can be subject to tax and require treaty benefits.

3.9.2 Treaty residence

(i) *Basic rule (Article 4(1) 1st Sent.)*

- (a) Under the DTAAs, a Resident of a contracting state means Resident of one of the states to the Treaty.
- (b) The term ‘Resident’ in a DTAA is different from the definition of the term under the Act or under erstwhile FERA or under present FEMA; however, the definition of Residence in the domestic tax law is the starting point to determine the residential status of a person under a Treaty.
- (c) The term “Resident” under a treaty means a person liable to tax in any of the contracting states (states signing the DTAA) by reason of domicile, residence, place of management, or any other criterion of similar nature.
- (d) It is the connecting factors that should trigger the liability to tax in a Contracting States for treaty residence. Where a person is liable to tax not because of the connecting factors

but because of other reasons, like the income being sourced in that State, that person does not fulfil the basic rule for treaty residence. The OECD Commentary uses the phrase 'comprehensive liability to tax' to describe this rule since under the tax laws of countries, residents are usually taxed on their global income, and for this reason, also become treaty residents. Notably, even if some income of a person is excluded from the scope of total income on which he is liable to tax, as long as he is taxed by reason of the connecting factors and not because income is sourced in that State, he fulfils the basic rule for treaty residence in that State.

(ii) Exception to the basic rule (Article 4(1) 2nd Sent.

(a) The second sentence carves out an exception from the basic rule (discussed above). 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. The second sentence was originally introduced to cover within its scope diplomats who are residents of the host country (because of their extended periods of stay there) but are usually granted exemption from including their global income to tax in that state due to their consular privileges. Since their global income (other than income from sources in the host state) are exempt, they are denied entitlement to the host state's treaties.

Over time, the scope of the second sentence has expanded to include foreign-held companies that are exempted from paying tax on their foreign income by privileges in domestic law tailored to attract conduit companies. Also covered within the exception are persons who are not subject to comprehensive liability to tax in a Contracting State though they are its residents but are considered resident of a third state pursuant to the tie-breaker rule between the two States.

(iii) Tie-breaker tests

- (a) If a person is "Resident" of both the Contracting States, it gives rise to uncertainty which needs to be resolved. This is done by applying what is known as the "tie breaker tests".
- (b) In order to access a treaty, a person should be "Resident" of one of the contracting states by reason of any of the connecting factors listed in paragraph 1.
- (c) In case a person is 'Resident' of both the contracting states, one has to apply the tie-breaker test provided for in paragraph 2 and 3 of Article 4 to decide his residence for the purposes of the relevant treaty. This is essential in order to apply the distributive rules in the treaty which allocate taxing rights between the Residence State and the other State. In the absence of a single treaty residence, the rules cannot be applied.
- (d) Tie - breaker tests for individuals consist of the following steps/stages -
 - (i) Where an individual has permanent home available to him. (Home – not house) that country is the state of his residence where he has permanent home.
 - (ii) If permanent home is available to him in both the countries then - that country, in which his personal and economic interests are closer, becomes his country of residence.

- (iii) If his personal and economic interests are indeterminate or he has no permanent home available in either country, then the country in which he is habitually resident (his habitual abode) is the country of his residence.
- (iv) If he has habitual abode in both the countries/ does not have habitual abode in either of them, then he is resident of that country of which he is a National.
- (v) If he is national of both the countries, or neither of them, then the revenue authorities of both the contracting states determine his status of residence by Mutual Agreement Procedure as laid down in the treaty.

(e) Paragraph 3 of Article 4 usually contains the provisions to determine residence for the purposes of the Treaty in case of non-individuals who are dual-resident. The paragraph provides that the dual-resident non-individuals to be resident of the Contracting State where their place of effective management (POEM) is situated. The term is not defined in treaties. The OECD Model (2017 Update) has replaced the POEM rule with a case-by-case determination by competent authorities of the two States by mutual agreement of the Contracting State of which such a person should be resident for the purposes of that treaty. While determining the treaty residence of such a person, the competent authorities shall have regard to its place of effective management, the place where it is incorporated and any other relevant factors.

Exceptions to the above rule

Under the treaty signed by India with Italy, Malaysia and Singapore, “Resident” is a “person who is resident according to taxation laws of the state”, that is to say, “Resident” as defined under the Act of respective states.

However, the India-USA DTAA is a very unique example. Paragraph 3 of Article 4 provides that “*Where, by reason of paragraph 1, a company is a resident of both Contracting States, such company shall be considered to be outside the scope of this Convention except for purposes of paragraph 2 of Article 10 (Dividends), Article 26 (Non-Discrimination), Article 27 (Mutual Agreement Procedure), Article 28 (Exchange of Information and Administrative Assistance) and Article 30 (Entry into Force)*”.(Emphasis supplied)

3.10 General Method of Taxation in Source States

Source States may use different methods to tax incomes for which they have reserved their rights to tax under a Convention. The common methods used are as follows.

Source States may:-

- (i) Levy tax on the income at full rates as per the domestic tax law.

Example: Profits earned by a permanent establishment or business/ professional incomes of a person earned though a fixed base in the source State are taxed at the full rate in the source State.

(ii) Agree to tax income at reduced rates i.e. maximum level is provided in the treaty on the rates of tax on incomes like Royalties, Dividend, and Interest etc.

(iii) Tax at periodically reduced rates

Example - Under Indo-UK DTAA, Royalties are taxable for the first five years @ 20 per cent and thereafter @ 15%.

3.11 Advance Ruling

In case of doubt about tax implications of the transactions, a Non-resident can take the benefit of Advance Ruling which has been incorporated under Chapter - XIX-B in the Act in 1993.

The Ruling is binding both on the person who approaches the Authority for Advance Ruling (AAR)²⁷ as well as the Tax Department.

For example, in the case of M.A. Rafik, [1995] (213 ITR 317), the AAR held that a resident of UAE, where presently there is no tax on personal income, is to be regarded as being liable to tax should there be levy of tax at a later date and hence, he can access the Treaty. This Ruling is binding on both M.A. Rafik and the Tax Department. Others cannot take advantage of it. However, in practice, it is seen that these Rulings do have a persuasive value.

It is however, advisable, that one ought to be sure, that a Resident of contracting State is actually liable to tax in that contracting state, and not rest on the belief or that the Treaty can be accessed even if there is no tax at present, but will be liable should there be a tax.

3.12 Tax Treaties Signed by India

As on June, 2022, India has signed Comprehensive Agreements (DTAAs) with 96 countries²⁸.

Contents of DTAAs – Analysis of Important Articles

3.13 Important Articles of a DTAA

We shall deal with some of the important Articles of the DTAAs, and some of the issues arising therefrom.

3.13.1 Permanent Establishment (PE)

Usually, Article 5 of the Treaty defines “Permanent Establishment”; whereas Article 7 of the tax treaty deals with “business profits”. Article 7 of the tax treaty provides that business profits of the resident of a Contracting State cannot be taxed in Source State unless there is a permanent establishment. Also, where there is a PE, only so much of profits can be taxed in the State of Source as is attributable to the PE situated therein. It is therefore essential to know what constitutes a PE; what can be considered as business profits and how does one determine

²⁷ Vide amendments made by the Finance Act, 2021, AAR is substituted by the Board for Advance Ruling (‘BAR’), discussed in Module D.

²⁸ <https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx>

profits attributable to a PE.

3.13.2 Concept of Permanent Establishment (PE)

Permanent establishment (PE) means a fixed place of business through which the business of an enterprise is wholly or partly carried on. In most of the Indian DTAs, Article 5 (PE) provides for the rules to establish the PE of a resident of the Contracting state in the Source State. Typically, Article 5(1) contains the basic rule for a PE and expresses the general concept of PE. It necessitates the following conditions to be satisfied to form a PE -

- (a) There must be a fixed place of business ('place of business' test);
- (b) The place must be at the disposal of the enterprise ('power of disposition' test);
- (c) Business of the entity must be carried on through that fixed place either wholly or in part ('business connection' test).

Some Judicial Precedents²⁹

In order to appreciate the full import of the term "PE" it would be worthwhile to refer to the decision of the Andhra Pradesh High Court in the Vishakhapatnam Port Trust Case. The Hon'ble Court made the following observation on "PE" "The words 'Permanent Establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country" [CIT V/s Vishakhapatnam Port Trust (1983), 144 ITR 146(AP)].

In the case of **XYZ/ ABC Equity Fund (2001) 250 ITR 194 (AAR)**, it has been held that whether or not a non-resident has a PE in India should be decided in each year. Merely because of the fact that there was no PE in a particular year does not mean that the non-resident cannot have a PE in India in a subsequent year. Further, the burden of proof is upon the revenue to prove the existence of a PE [Decca Survey Overseas Ltd UK V/s. ITO [2004-TIOL-102-ITAT-Mum].

Article 5(1) provides that business should be carried out. However, the UN Convention does not define business but, the Income-tax Act, 1961 has defined 'business' under section 2(13). In the case of **Linklaters LLP V/s. ITO (2010) 132 TTJ 20 (Mum)**, it has been held that Article 5 covers not only commercial or industrial establishments, but also professional services. Further, in the case of **Clifford Chance V/s. DCIT (2002) 82 ITD 106 (Mum)**, it has been held that merely because a person happens to be a qualified professional does not mean that the activity carried out cannot be considered as business.

The Supreme Court in case of **Formula One World Championship Ltd. V/s CIT (Civil Appeal No. 3849 of 2017)** held that international circuit of Formula One championship constitutes a PE even though the aforesaid race was conducted only for three days in a year. It observed the three characteristics that were needed to constitute a PE are (i) existence of a fixed place of

²⁹ The Law and Practice of Tax Treaties – An Indian Perspective – Second Edition

business; (ii) business of the enterprise is wholly or partly carried on through that place; and (iii) such place is 'at the disposal' of the enterprise.

The Supreme Court in case of **DIT vs Samsung Heavy Industries Co. Ltd (Civil Appeal No. 12183 of 2016)** held that where a Korean company, was awarded a project by ONGC for purpose of surveys, design, etc., in view of fact that assessee was not carrying on its core business through its Project Office in India, said Project Office would not constitute permanent establishment within meaning of article 5(1) of DTAA between India and Korea. The Court observed that condition precedent for applicability of article 5(1) of DTAA and ascertainment of a PE is that it should be an establishment through which business of an enterprise is wholly or partly carried on and profits of foreign enterprise are taxable only where said enterprise carries on its 'core business' through PE.

3.13.3 Forms of presence which are included in a PE

Apart from the concept of fixed place PE, as discussed above, there exist various other forms of PE like service PE, dependent agent PE, PE in relation to building sites or installation projects, etc. Article 5(2) generally contains an illustrative list of the places which, prima facie, constitute a PE. The placement of different forms of PE varies in different DTAA's and have to be accordingly interpreted. An illustrative list of the various inclusions to the term PE is as follows:

- (a) A place of management.
- (b) A branch.
- (c) An office.
- (d) A factory.
- (e) A workshop.
- (f) A sales outlet.
- (g) A warehouse used for delivery of goods (only in case of UN Model).
- (h) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
- (i) A building site, construction, installation of a project.

In OECD Model – period specified is more than twelve (12) months.

In UN Model - period specified is more than six (6) months.

In UN Model, the definition is further widened to include supervisory activities in connection with such project and assembly activity. This would include even consultancy services through the employees of the concern over a period of six (6) months within a twelve (12) month timeframe.

Once a particular activity lasts for the required length of time, say, 6 or 12 months, as the case may be, the PE is constituted from the first day of the commencement of the activity.

- (j) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if the activities of that nature continue within a contracting state for a certain period of time.

In OECD Model - the service PE clause is absent.

In UN Model – period specified is a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

- (k) Though the concern may not have a fixed place of business in the Source State, its business may be carried on through a dependent agent. Dependent agents are those who have the authority to conclude contracts³⁰ on behalf of the concern and can bind the concern, especially where such authority is exercised regularly and not in isolated cases. If the authority to conclude contracts is exercised regularly, it establishes the presence of a PE. The dependent agent PE paragraphs have undergone significant changes as an outcome of the BEPS Project. The OECD Model 2017 Update has adopted these changes in paragraph 5 of Article 5 which reads as follows-

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Thus, the scope of dependent agent PE has been widened to include activities of the agent which lead to the conclusion of contracts for the non-resident enterprise if the agent plays a principal role even if he does not conclude the contracts himself.

³⁰ In the Indian Context, it is known as Business Connection under section 9(1)(i) of the Income Tax Act, 1961. Also, Finance Act, 2018 has inserted the concept of "Significant Economic Presence" by way of explanation 2A to section 9 of the Income-tax Act, 1961.

3.13.4 Activities/ Instances which do not constitute a PE

These are certain activities which are specifically excluded from the scope of PE which are preparatory or auxiliary nature. Reference in this regard can be made to Article 5 of DTAA's. The following exclusions exist in most of the DTAAs:

- (a) Use of facilities for mere storage or display of goods of the enterprise (not of others).
- (b) Maintenance of a fixed place for mere storage and display of goods of the enterprise (not of others)
- (c) Under the OECD Model, the use of facilities/maintenance of fixed place for mere delivery of goods belonging to the enterprise is also excluded. In other words, such places shall not constitute as a PE.
- (d) Maintenance of fixed place for purchase of goods or collecting information.
- (e) Maintenance of a fixed place of business for preparatory or auxiliary activities; this is so because the auxiliary activities are in the nature of preparatory services and are remote from the realisation of profit.

Questions often arise as to which are auxiliary or preparatory activities. It will depend upon the facts of each case³¹.

- (f) Maintenance of stock of goods/merchandise belonging to the enterprise solely for processing by another enterprise.
- (g) A subsidiary is not necessarily considered a PE. Similarly, a holding company is also not necessarily a PE. If the facts suggest that the subsidiary / holding co. are acting as a dependent agent and / or a P.E, profits may be attributable to the Source State.

Recent action taken under BEPS to address artificial claim of the benefit is discussed later in this chapter.

Some Judicial Precedents³²

In the case of **Motorola Inc & Others V/s. DCIT (2005) 95 ITD 269 [Del (SB)]**, it has been held that mere possession of a mailing address in State S without an office, assets or employees, telephone listing or bank account does not result in a PE. It was also held that occasional use by a foreign enterprise of business premises of a group company (allowed gratis) in State S does not create a PE.

³¹ Generally, a liaison office (LO) of a non-resident in the other Contracting State would not be considered as a PE for tax purposes unless the facts of the case state otherwise. In India, in the case of *Brown & Sharpe Inc V/s ACIT [2014] 41 taxmann.com 345 (Del)*, it was observed that employees engaged by the LO of a foreign company were paid by the LO, some remuneration for achieving certain level of sales. Further, various other facts also suggested that business was being carried out through the LO and therefore, there was some income attributable to the LO of the foreign company.

³² The Law and Practice of Tax Treaties – An Indian Perspective By Nilesh Modi– Second Edition

The Madras High Court in the case of **Poompuhar Shipping Corpn Ltd V/s. ITO [TS-528-HC-2013]** has held that there is a PE when facility is guaranteed for berthing at a port in State S, for foreign ships provided on time charter basis.

In the case of **Galileo International Inc V/s. DIT³³ [ITA 851/2008-Del HC]**, it was held that a Computer Reservation System (CRS) owned by a US based company, accessed by travel agents in India (hardware, software and connectivity provided by US Co) amounted to a PE for following reasons: -

- (a) CRS partially existed in the hardware installed in India.
- (b) US Co. exercised complete control over computers installed at the premises of subscribers and computers could not be shifted from one place to another within the premises of the subscriber.

In case of **DIT V/s. Mitsui & Co. Ltd. [ITA 13 and 334/2005-Del HC]**, it has been held that where the liaison office was not used for carrying out business or trading activity and is solely used for the purpose of search or display of goods or collecting information or for any other activity, it does not constitute a PE.

The Supreme Court case of **ADIT V/s. E-Funds IT Solution Inc. [Civil Appeal No. 6082 of 2015]** has held that the Indian subsidiary of a foreign company providing back-office support services does not constitute a PE in absence of any fixed place of business in India which is at the disposal of such foreign company.

In case of **DIT vs. Samsung Heavy Industries Co. Ltd (Civil Appeal No. 12183 of 2016)**, it has been held that foreign company was not carrying on its core business through its Project Office in India, said Project Office would not constitute permanent establishment within meaning of article 5(1) of DTAA between India and Korea.

In case of **GE Energy Parts Inc. (IT Appeal no. 621 of 2017 & Oths.) [2019] 411 ITR 243** Hon'ble Delhi High Court observed that where liaison office of US Company established to act as communication channel, was carrying core activity of marketing and selling highly sophisticated equipments to US company, LO was fixed place P.E. of Assessee company in India.

In case of **UOI vs. U.A.E. Exchange Center (Civil Appeal No. 9775 of 2011) dated 24 April 2020**, Assessee, a limited company incorporated in UAE, was engaged in offering remittance services for transferring amounts from UAE to various places in India. On request of NRI remitter, Assessee used to send instruments/cheques through its liaison offices in India to beneficiaries in India, designated by NRI remitter. Said transaction(s) had completed with remitters in UAE and no charges towards fee/commission were collected by liaison offices in that regard. In view of the facts involves, the Supreme Court held that no tax can be levied or

³³ The issue is pending before the Supreme Court.

collected from the liaison office of the Assessee in India in respect of the primary business activities consummated by the Assessee in UAE and activities carried out by the liaison office are of preparatory and auxiliary character.

3.13.5 Advantages of the PE Concept

DTAA helps in overcoming the rigors of Section 9(1)(i) of the Income-tax Act, 1961 i.e. the concept of business connection in the case of a non-resident. Normally a non-resident assessee has to declare his business profits attributable to 'business connection' and 'business operations' in India – which is very wide and nebulous in the absence of a DTAA between the two countries. The scope of PE under DTAA is narrower than the concept of business connection as defined under the Act. A Non-resident would not attract tax merely because it has a business connection in India unless it has a PE in India.

The following illustration highlights the difficulties posed in the absence of PE under a Treaty.

In the case of **Barendra Prasad Roy vs. ITO 129 ITR 295**, a U.K. barrister came to India and argued a case, which lasted a fortnight. **The Indian solicitors did not brief him or pay him any fees but merely** assisted at the hearing of the case. The Supreme Court found that, since the **Indian solicitors** had handed over the records to the London solicitors who then engaged the English barrister, there was an indirect business connection between the Indian solicitors and him. The SC held that the English barrister had business connection with the Indian solicitors who were therefore liable as agents under Section 163(1) in respect **of the fees paid abroad by the London solicitors who had briefed the barrister.**

Had there been a treaty between U.K. and India at the relevant point in time, the issue of "Business Connection" would not have arisen because the U.K. barrister would not be considered to have a Permanent Establishment in India, in terms of the Treaty between U.K. and India. He would have been liable to tax in India only if he had a PE / fixed base in India and had carried on the profession in India through the PE/ fixed base.

Trading in a country from/through PE would give rise to taxable income³⁴ attributable to PE but merely trading with a country would not give rise to liability to tax, though there could be a business connection. In other words, doing business in a country through substantial presence in the form of a branch, fixed place, office, factory, dependent agent etc. would give rise to PE but doing business with a country by way of export of goods/ services from a place outside India may not give rise to a PE.

3.13.6 Some interesting principles emanating from various judicial precedents:

- (a) Even if a concern frequently changes its address (place of business) in the host country, it may still have a 'PE' in the host country.
- (b) If a concern merely has a liaison office to collect the data in the host country, but the

³⁴ The concept of Force of attraction rule also plays a significant influence in taxability of a PE

contracts are directly concluded from abroad, it may not constitute a PE.

- (c) A concern having brass plate address at its attorney's office and the orders received at the attorney's office are merely forwarded to the concern abroad, such a concern cannot be said to have a PE
- (d) An MNC secures an order for setting up of a power project in India and it concludes the contract through its authorised representative in India, it can be said to have a PE in India.
- (e) Where a non-resident company keeps a a machine in an Indian hospital for which it receives a fixed amount, the non-resident company could be said to have 'PE' through the presence of its machine in India.
- (f) Where sale of goods takes place outside India and title in goods is also passed outside India, the same would not result in constitution of a PE.

Let us now deal with another important concepts.

3.13.7 Business Profits

In most treaties, this concept is usually defined in Article 7 of both, the UN and the OECD Models. It covers profits arising from business carried on through the PE. Profits are computed under ordinary commercial principles allowing legitimate business expenses as deductions.

Under the U.N. Model, payment to Head Office (Royalties, Interest, Fees, and Commission) is restricted by the domestic law of the country where PE is situated. (In India, reference to section 44C of Act becomes important).

Exceptions to the above rule are contained in the treaties with Austria and Mauritius. However, reimbursement of expenses³⁵ actually incurred by Head Office is allowed to be deducted.

In the case of Banking Companies, interest paid to Parent Company is allowed to be deducted. In case the PE merely purchases the goods for the enterprise, profits do not accrue to the enterprise.

Profits from operation of ships or aircrafts in international traffic are not covered by this Article because they are treated separately under other Article(s).

Some Judicial Precedents³⁶

The following income has been held as **business profits** in accordance with the provisions of Article 7 of the DTAA: -

Interest income from deposits made to Reserve Bank of India as a precondition to carry out banking business – **Mitsui Bank Ltd V/s. IAC (1989) 35 TTJ 426 (Mum)**

³⁵ In India, in some cases, re-imbusement has been a critical issue. Therefore, one needs to analyse the possible repercussions under the Income Tax Act, 1961

³⁶ The Law and Practice of Tax Treaties – An Indian Perspective by Nilesh Modi – Second Edition

Consideration received in lieu of assignment of the agreement to supply goods – **Laird Technologies India P Ltd [(2010) 323 ITR 598 (AAR)]**

A single transaction may amount to business and therefore the profit should be considered as business profit – **Morgan Stanley & Co. International Ltd [(2005) 272 ITR 416 (AAR)]**

Attribution of Profits

In re (1997) 228 ITR 487 (AAR), it has been held that profits arising out of activities carried out outside the State in which PE is situated may be attributable to the PE. In such cases, tax may be levied on the PE.

In **ADIT V/s. Bureau Veritas (2011) 45 SOT 67 (Mum) (URO)**, it has been held that reimbursement of expenses in relation to services provided by head office cannot be treated as income attributable to the PE.

In case of **Nokia Solutions and Networks OY (IT Appeal Nos 503 of 2022)**, it has been held that for computing profits attributable to Indian PE of assessee, a Finland based company, net profit margins of assessee were to be applied and since assessee recorded a global net loss in relevant assessment year, no profit / income would be attributable to PE.

Burden of Proof Regarding Income Attribution

In the case of **ACIT V/s. Epcos AG (2009) 28 SOT 412 (Pune)**, it is held that it is for the revenue authorities of Source State to demonstrate that entire income of non-resident is attributable to the PE in the Source State.

However, if all the operations are carried out by the non-resident through its PE and the head office is merely a letter box company, it is justified to attribute entire profits to the PE in the Source State.

3.13.8 Associated Enterprise

In simple terms, it means a controlled company / unit. Control may be by way of holding of capital or voting rights or management or any other manner.

If there is a common control of the unit, suppressed profits on transactions which are not “Arm’s Length” transactions can be brought to tax as deemed profits. The Revenue must establish that there exists common control and the profits have been suppressed.

- **“Force of Attraction Rule”**

Article 7(1) of the UN Model gives the State where a PE is located the right to tax the profits attributable to the PE and, additionally, also the profits from sales in that State of goods or merchandise of the same or similar kind as those sold through the PE or other business activities carried on in that State of the same or similar kind as those effected by the PE. The additional taxing rights, popularly called the force of attraction rule, are to overcome artificial structuring of business in the source country to avoid certain transactions being taxed in spite there being PE in that country.

Usually, profits arising out of activities of PE are considered as Business Profits. However, a non-resident person may carry on operations through an independent agent in respect of goods dealt with by/through the PE. They may also carry-on similar activities as are carried on by the PE through an Independent Agent and derive considerable profits. In such a case, the profits made by the multinational company through the medium of Independent Agent do not get taxed. Hence, the UN Model covers transaction of the above type though not carried on by the PE but carried through the medium of Independent Agent/others. Such activities are considered as giving rise to Business Profits and taxed accordingly.

Some Judicial Precedence³⁷

In the case of **WNS Global Service UK Ltd [(2013)-TII-81-ITAT-MUM-INTL]**, it has been held that for the purpose of triggering the Force of Attraction Rule, it is not necessary that the goods must not be sold through the PE nor it is required to have any connection / involvement with the PE.

3.13.9 Base Erosion Profit Shifting Action Plan 7

In 2013, the OECD/ G20 Action Plan on Base Erosion and Profit Shifting (BEPS) called for a review of the definition of PE to prevent the use of certain common tax avoidance strategies, such as:

- Use of Commissionaire arrangements and similar strategies.
- Splitting-up of construction contracts for avoidance of construction PE; and
- Fragmentation of activities for taking undue advantage of PE-exclusion provisions in tax treaties.

Besides the above-mentioned aspects, the BEPS Final Report on Action Item 7 also covers few other related matters such as the meaning of “independent agent” relevant for dependent agency PE.

3.13.10 Interest

• Concept

The term “Interest” means “income from debt claims of every kind”. It is usually covered under Article-11 of a Treaty. It is defined in the UN Model convention so as to include:

- Income from Government Securities;
- Income from Bonds or Debentures;
- Premia and prizes attached to Government Securities, Bonds or Debentures.

However, it excludes penalty of any kind for late payment. It is irrelevant whether the debt claim is secured or unsecured. It is also not relevant whether or not the debt claim carries any right to

³⁷ The Law and Practice of Tax Treaties – An Indian Perspective – Second Edition

participate in debtors' profits. In all cases income from debt claims would be treated as "interest".

The term, "debt claim" implies that provision of funds is not subject to the hazards of the enterprise's business. Thus, if participation of profits rests upon such risk bearing funds, income therefrom will not be treated as "interest".

Premia and prizes are considered as "interest". Thus, premia paid in excess of redemption value of bonds may constitute "negative interest". However, profit or loss on sale of a security does not constitute "interest".

- **Taxability**

The Scheme of taxation of "interest" as per the UN Model convention is more or less similar to that of "dividend".

The Model convention provides for taxability of "interest" as follows:

1. At first instance, interest is taxable in the State of Residence of the recipient.
2. Besides, interest is also taxable in the State of Source according to local tax laws.

However, if certain given conditions are fulfilled, then taxability in the State of Source can be at a concessional rate.

The conditions prescribed for concessional tax treatment in the state of Source are different under different DTAA's. However, generally a common condition is that the recipient of interest is the beneficial owner³⁸ of interest.

Following DTAA's are examples where interest is taxable only in the state of Source subject to fulfilment of the conditions specified therein -

- Austria
- Finland
- Greece
- Libyan Arab Jamahiriya
- Malaysia
- United Arab Republic (Egypt)

Many treaties provide for exemption from tax if the recipient of the interest is the government of the other state or a government agency or a government owned bank. Most treaties provide for exemption or concessional rate of tax if the recipient is a bank.

The term "state of Source" mentioned above means the state in which interest accrues. Under the UN Model, interest is deemed to arise in a contracting state where the payer is³⁹:

³⁸ The expression "beneficial owner" is used to counter the use of treaty shopping methods. For detailed understanding on what is treaty shopping, refer paragraph 6 of the Anti-Avoidance chapter of this book

³⁹ In various Indian DTAA's and also in section 9(1)(v) where interest income is deemed to accrue or arise in India,

- (i) state itself
- (ii) a political sub-division
- (iii) a local authority
- (iv) a resident of that state
- (v) a PE/FB (Fixed Base) situated in that state in connection with which the indebtedness was incurred.

- **Arm's Length Rule**

Where the payer of interest and the beneficial owner of interest have any special relationship, then the excess element of interest (if any) is taxed as per the provisions of local laws, and the DTAA will not apply.

Instances of such unreasonableness could be where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or his subordinate to a group having common interest with him. The concept of special relationship also covers relationship by blood or marriage and, in general, any commonality of interest giving rise to payment of interest.

Some Judicial Precedents⁴⁰

In the case of **Vijay Ship Breaking Corporation (2003) 261 ITR 113 (Guj)**, it was held that interest payment by way of irrevocable letter of credit by buyer will be considered as interest paid to the seller.

In **Kesoram Industries & Cotton Mills Ltd [(1996) 59 ITR 767 (SC)]**, it has been held that a liability which is contingent is not a debt in present or in future. But if there is a debt, the fact that the amount is to be ascertained does not mean to undermine its classification as debt and what remains is only the quantification of the amount.

DCIT V/s. McDermott International Inc [(2009)-TIOL-336-ITAT-DEL], it has been held that although payment of interest was not provided for in the services agreement but, the arbitrators, under the provisions of Interest Act, 1978, using their discretionary powers entitled the taxpayer with the same. The interest awarded was regarded as interest and not a judgment debt. Contrary to above, it has been held that the same is not taxable under Article 11 – **Islamic Investment Co V/s. UOI [(2004) 265 ITR 254 (Bom)]**

3.13.11 Dividends

- **Concept**

The notion of “dividend” basically concerns distribution of profits by a body corporate. This is usually covered under Article –10 of a Treaty.

one will observe such a similar position.

⁴⁰ The Law and Practice of Tax Treaties – An Indian Perspective by Nilesh Modi – Second Edition

- The UN Model Convention defines the term “dividend” to mean income from
 - Shares
 - “Jouissance” Shares
 - “Jouissance” Rights
 - Mining Shares
 - Founders’ shares
 - Other rights (not being “Debt Claims”) participating in profits.
 - Other corporate rights which are subjected to the same taxation treatment as income from shares by the local laws.
- Definitions in UN Model and OECD Model are identical.
- Most of the DTAA’s do not include the following items -
 - “Jouissance” Shares
 - “Jouissance” Rights
 - Mining Shares
 - Founders’ shares

In the Indo-US Treaty, the following additional item is included in the definition of Dividend -

“Arrangements (including debt obligations) carrying the right to participate in profits to the extent so characterized under local laws.”

Thus normally, income from convertible debentures is not “dividend”. Distribution of profits by partnerships is not “dividend”. Again, payments constituting a reimbursement of capital in any form whatever are not regarded as “dividends”. All this, however, is subject to the caveat that if any payment is, by a fiction of law, treated as “dividend” for the purposes of tax laws of a contracting state, then, for the purposes of the DTAA, it is liable to be treated as “dividend” as well.

For example, distribution to shareholders on liquidation or reduction of capital is regarded as “dividend” under Section 2(22) of the Indian Income Tax law. Such distribution is also to be regarded as dividend for the purposes of DTAA, following the UN model definition.

• **Taxability**

The Model Conventions provide for taxability of dividend as follows:

1. At first instance, dividend is taxable in the state of Residence of the recipient.
2. Besides, dividend is also taxable in the state of Source according to local tax laws.

However, if certain given conditions are fulfilled, then the taxability in the state of source is at a concessional rate.

The conditions prescribed for concessional tax treatment in the state of source are different under different DTAA's. However, generally, the conditions are that the recipient of dividend is–

- (a) The beneficial owner of dividend;
- (b) a Company; and
- (c) a holder of some specified minimum shares/voting power in the Company which declares dividend.

● **The concessional rate of tax for Dividend and Interest as per India's DTAA, with some countries**

Concessional Tax Rate in Source country under select DTAA's subject to fulfilling the conditions specified in the respective tax treaties:

	DTAA Country	Dividend	Interest
1.	United States	15-25%	10-15%
2.	United Kingdom	10-15%	10-15%
3.	Germany	10%	10%
4.	Japan	10%	10%
5.	Mauritius	5-15%	7.5%
6.	Malta	10%	10%
7.	U.A.E.	10%	5-12.5%
8.	Cyprus	10%	10%
9.	France	10%	10%
10.	Italy	15-25 %	15%

The above rates are to be applied on gross amount of dividend or interest.

In case of Greece, however, dividend is taxable only in the state of Source.

● **Provisions of Indo-UK DTAA**

Indo-UK Treaty

Taxability of Dividend

Payer Company	Resident of UK	Resident of India
UK	Not Applicable	1. Taxable in UK in all cases; 2. Taxable also in India @ 15 % on gross dividend subject to section 115BBD ⁴¹ .

⁴¹ Section 115BBD levies tax at concessional rate of 15% on dividend income if an Indian Company holds 26% or more in a specified foreign company.

India	1. Taxable in India at rates prescribed in tax treaty or domestic laws, whichever is less 2. Taxable in UK subject to tax laws in UK.	Not Applicable
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- **Taxability as Business Profits**

The Article dealing with taxability of “dividend” generally provides that dividends would be taxed as “Business Profits” or as “Independent Personal Service”, if:

(a) a business is carried on through a Permanent Establishment (PE); or Independent Personal Services are carried on through a Fixed Base (FB)

and

(b) Shareholding is effectively connected with such PE or FB.

In other words, in such cases dividend is taxable in the state of Source (generally) as part of profits of a PE/FB situated there and owned by the dividend’s beneficiary who is Resident of the other state⁴².

- **Miscellaneous Provisions**

Generally, all DTAs prohibit extra-territorial taxation of dividends. For example:

An Indian company has a branch in UK, which distributes dividends. Then, UK cannot tax such dividends unless:

(a) it is received by a resident of UK; or

(b) holding of shares is effectively connected with the PE/FB in UK.

DTAs normally provide for prohibiting a Contracting State from taxing undistributed profits of a non-resident company. In the above example, even if UK laws generally levy special tax on undistributed profit, UK cannot levy such tax on the Indian company merely because profits are derived from UK.

3.13.12 Royalties and Fees for Technical Services

Almost all DTAs contain a separate article dealing with “Royalties”. ‘Royalties’ are usually covered under Article 12 of a Treaty. Some DTAs also have another Article dealing with Fees for Technical Services (FTS) while some others have a common Article dealing with both Royalties and FTS. A few other DTAs do not deal with FTS at all.

- **Concept**

The term “Royalty” as defined in the UN Model Convention covers the following payments of

⁴² One can say that this is effectively to give effect to the concept of “reasonable attribution of income to PE”

any kind received in consideration for:

A. The use of; or the right to use; any copyright

- of Literary Work
- of Artistic Work
- of Scientific Work

It Includes

- Cinematograph Films
- Films or Tapes used for Radio or T.V.
- Patent
- Trademark
- Design or Model
- Plan
- Secret Formula or Process
- Transmission by satellite, cable, optic fibre or similar technology⁴³

B. The use of or the right to use

- Industrial Equipment
- Commercial Equipment
- Scientific Equipment

C. For Information concerning

- Industrial Experience
- Commercial Experience
- Scientific Experience.

• **Equipment Royalty: OECD Model**

The OECD Model does not include payments for the use of or for the right to use industrial, commercial or scientific equipment as part of “Royalty.” Paragraph 9 of the OECD Model Commentary suggests that such income would fall under the rules of taxation of business profits under a separate Article⁴⁴.

• **Fees for Technical Services**

The term “Fees for Technical Services” (FTS) has not been defined in the OECD Model convention. The UN Model convention (2017 update) has introduced Article 12A relating to Fees

⁴³ India Hungary DTAA; India Croatia DTAA

⁴⁴ In the Indian context, there have been significant amendments in section 9(1)(vi) by the Finance Act, 2012.

for Technical Services as under:

1. Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed ___ percent of the gross amount of the fees [the percentage to be established through bilateral negotiations].

3. The term “fees for technical services” as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made:

(a) to an employee of the person making the payment;

(b) for teaching in an educational institution or for teaching by an educational institution; or

(c) by an individual for services for the personal use of an individual.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with:

(a) such permanent establishment or fixed base, or

(b) business activities referred to in (c) of paragraph 1 of Article 7.

In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.

6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State and such fees are borne by that permanent establishment or fixed base.

7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Even prior to insertion of Article 12A in UN Model convention, many of the tax treaties signed by India contained FTS related provisions. It has been defined to mean:

Payment of any kind

- A. To any person other than
 - Employee, or
 - Individual
 - For Independent Personal Services
- B. In consideration for services of the following nature
 - (a) Managerial,
 - (b) Technical,
 - (c) Consultancy, or
 - (d) Provision of services of Technical Personnel or other Personnel.

- **Fees for Included Services (FIS)**

FIS Clause found in the Indo-US DTAA is a variant of FTS (Fees for Technical Services) Treaty. In this treaty, this term has been defined to mean:

- (a) payment of any kind
- (b) to any person
- (c) in consideration for rendering of the services of the following nature:
 - (i) technical;
 - (ii) consultancy;
 - (iii) provision of service of technical or other personnel.

However, all such services do not qualify as “Included Services”. It is only if such services as mentioned above satisfy one of the two specified conditions, that they can be regarded as “Included Services”. These conditions are:

- (a) Such services are ancillary and subsidiary to the application or enjoyment of rights for which royalty payments are received; or

- (b) Such services
- (i) make “available” technical knowledge, experience, skill, know-how, or processes; or
 - (ii) consist of development and transfer of technical plan or technical design.

Thus, the scope of this definition is much narrower than the generally followed definition of FTS described above.

It may be worth mentioning that similar definition is found for “fees for technical services” in some other treaties that India has signed – e.g. Indo-UK Treaty, Indo-Singapore Treaty.

The memorandum of understanding dated May 15, 1989 signed between India and USA explains the phrase “make available” in the following words:

“Generally speaking, technology will be considered “made available” when the person acquiring the services is enabled to apply the technology. The fact that the provision of services may require technical input by the person providing the service does not per se mean that technical knowledge, skills etc., are made available to the person purchasing the services. Similarly, the use of the product which embodies technology shall not per se be considered to make the technology available”.

In other words, if a technician renders some services by which, say a machine is repaired, but the owner of the machine is not enabled to apply the same technology himself, it would not amount to Included Services. It may be said that ‘making available’ technology is different from making available merely the fruits of the technology. Former is Included Services while latter is not.

- **Impact of the Judge made law in India for Fees for technical services / Fees for included services⁴⁵**

In the Indian scenario, in the absence of definitions of the expressions “Managerial, Technical or Consultancy services”, issues such as what one means by these terms has remained a subject matter of litigation. The law so far, seems to have settled in the light of few undernoted decisions pronounced by Tax Tribunals, High Courts and the Supreme Court.

Managerial Services

In the case of **C.I.T. vs. Bharti Cellular Limited and others⁴⁶**, the Delhi HC has observed as follows:

“The word managerial has been defined in the Shorter Oxford English Dictionary, Fifth Edition

⁴⁵ The expression “Fees for technical services” has been used under section 9(1)(vii) of Income Tax Act, 1961 whereas in the Indo-US DTAA, it is the expression “Fees for included services” which is used. There are some differences in the two expressions. However, in many cases, it has been used interchangeably and interpreted as more or less one and the same. It is therefore, necessary to understand the meaning provided before moving forward with any such issue

⁴⁶C.I.T. vs. Bharti Cellular Limited and others (2008) 175 Taxman 573

as of pertaining to, or characteristic of a manager, especially a professional manager of or within an organization, business, establishment, etc. The word manager has been defined, inter-alia, as a person whose office it is to manage an organization, business establishment, or public institution, or part of one; a person with the primarily executive or supervisory function within an organization etc., a person controlling the activities of a person or team in sports, entertainment, etc.

It is therefore, clear that a managerial service would be one which pertains to or has the characteristic of a manager. It is obvious that the expression manager and consequently managerial service has a definite human element attached to it. To put it bluntly, machine cannot be a manager.”

Technical vs. Consultancy Services

The Honorable SC in the case of **GVK Industries Ltd. v The Income Tax Officer & Anr**⁴⁷ observed as follows -

“By technical services, we mean in this context services requiring expertise in technology. By consultancy services, we mean in this context advisory services. The category of technical and consultancy services are to some extent overlapping because a consultancy service could also be technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in technology is required to perform it”

Further in the case of **C.I.T. vs. Bharti Cellular Limited and others**⁴⁸, the Delhi HC has observed as follows:

“Similarly, the word “consultancy” has been defined in the said dictionary as “the work or position of a consultant; a department of consultants.” “Consultant” itself has been defined, inter-alia, as “a person who gives professional advice or services in a specialized field.” It is obvious that the word “Consultant” is a derivative of the word “Consult” which entails deliberations, consideration, conferring with someone, conferring about or upon a matter. Consult has also been defined in the said dictionary as “ask advice for, seek counsel or a professional opinion from; refer to (a source of information); seek permission or approval from for a proposed action.” It is obvious that the service of consultancy also necessarily entails human intervention. The consultant, who provides the consultancy service, has to be a human being. A machine cannot be regarded as a consultant.

From the above discussion it is apparent that both the words managerial and consultancy involve a human element. And, both managerial service and consultancy service, are provided by humans. Consequently, **applying the rule of noscitur a sociis**⁴⁹, the word technical as

⁴⁷Civil Appeal No. 7796 of 1997 dated February 18, 2015

⁴⁸C.I.T. vs. Bharti Cellular Limited and others (2008) 175 Taxman 573

⁴⁹The meaning of a word is or may be known from the accompanying words. Under the doctrine of **Noscitur a sociis**, the meaning of questionable words or phrases in a statute may be ascertained by reference to the meaning of words or phrases associated with it.

appearing in explanation 2 to Section 9(1)(vii) would also have to be construed as involving a human element”.

In this context, a reference to the meaning of “Consultation” in Black’s Law dictionary, eighth edition; the word “Consultation” has been defined as an Act of asking the advice or opinion of someone (such as a lawyer). It means a meeting in which a party consults or confers and eventually it results in human interaction that leads to rendering of advice. (Emphasis supplied)

However, in CIT v Kotak Securities Ltd [2016] 383 ITR 1, the Supreme Court cautioned against a general proposition that FTS requires human intervention. The Court held:

“7. “Managerial and consultancy services” and, therefore, necessarily “technical services”, would obviously involve services rendered by human efforts. This has been the consistent view taken by the courts including this Court in Bharti Cellular Ltd’s. case (supra). However, it cannot be lost sight of that modern day scientific and technological developments may tend to blur the specific human element in an otherwise fully automated process by which such services may be provided. The search for a more effective basis, therefore, must be made.

8. “Technical services” like “Managerial and Consultancy service” would denote seeking of services to cater to the special needs of the consumer/user as may be felt necessary and the making of the same available by the service provider. It is the above feature that would distinguish/identify a service provided from a facility offered. While the former is special and exclusive to the seeker of the service, the latter, even if termed as a service, is available to all and would therefore stand out in distinction to the former.”

- **Taxability**

Taxability of ‘Royalty’ is different under the two model conventions -

(a) UN Model provides as follows:

- Taxability in the state of Residence of the recipient; and
- Taxability also in the state of Source, but at a concessional rate if the recipient is the ‘beneficial owner’ of royalty.

(b) OECD Model provides as follows -

- Taxability only in the state of residence if the recipient is the beneficial owner of royalty.

- **Concessional Rates**

Royalty and Fees for Technical Services (FTS) are taxed at concessional rates under the DTAAAs, in order to encourage the treaty partners in the transfer of technology.

- **Concessional Tax Rates in respect of Royalties and FTS (Some DTAAAs)⁵⁰**

⁵⁰ Finance Act, 2015 has amended section 115A of the Income Tax Act, 1961. Now, tax payment in India on account of such income may be more beneficial than the treaty provisions. This is a case where provisions of the domestic laws itself are more beneficial than the treaty provisions.

The concessional rates are summarized in Table given below in respect of some select countries.

	DTAA Country	Royalty	FTS
1.	USA	10% / 15% in some cases	10%/15% in some cases
2.	U.K.	10% / 15% in some cases	10% / 15% in some cases
3.	Kenya	20%	17.5%
4.	Japan	10%	10%
5.	Poland	15%	15%

- **Taxability of Royalty as Business Profits**

The Articles dealing with Royalty generally provide that royalty would be taxed as “Business Profits” or as “Independent Personal Services” if:

(a) business is carried on through a Permanent Establishment (PE)

or

Independent Personal Services are rendered through a Fixed Base (FB)

and

(b) the right or property in respect of which the royalties are paid is effectively connected with such PE or FB.

In other words, in such cases, royalties are taxable in the state of Source as part of profits of the PE/FB situated therein and owned by the royalties’ beneficial owner who is a Resident of the other state.

This is provided to prevent misuse of the concessional rate of tax for Royalties.

- **Arm’s Length Rule**

This is a rule to prevent the misuse of concessional rate of tax on royalties provided in the DTAA’s. It works in a manner provided as below -

Where the payer of royalties and the beneficial owners of royalties have any special relationship, then the unreasonable element of royalties (if any) is taxed as per the provisions of local laws and the concessional tax rate provided in the DTAA’s will not apply.

Royalty paid or payable should be reasonable or at least appear to be reasonable.

Reasonableness of the royalties would be ascertained having regard to the use, right or information for which Royalties are paid.

- **What constitutes / does not constitute Royalty?**

— Payment for specified rights constitute royalty irrespective of whether these rights are required to be recorded in a public register or not;

- Payment for fraudulently copying or infringing the right also constitutes royalty;
- Payment for granting of right to use “know-how” is royalty. However, if the grantor guarantees the result of know-how by rendering services, it would either be FTS or Business Profits or Independent Personal Services but not royalty.
- Payment for lease of industrial, commercial or scientific equipment is treated as royalty under the UN Model. However, if the lessee gets the ownership right at the end of lease period without any payment (or nominal payment), the transaction could be regarded as credit sale or hire purchase or sale by installments and as such would not be regarded as royalty. Such cases would fall under the Articles dealing with Business Profits or Capital Gains.
- Payment in consideration of computer software may represent “royalty” in limited cases where the payment is for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright) and where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. E. g. — A payment for license to reproduce and distribute to the public software incorporating the copyrighted program or to modify and publicly display the program would constitute royalty.
- Payments received for the sale of shrink-wrapped computer software has been held to be not in the nature of royalties.⁵¹

- **What constitutes/does not constitute FTS?**

Payments for rendering services ancillary or subsidiary to enjoyment of copyright, patents, design, secret formula etc. may constitute FTS.

Under Indo-Israel, Indo-Netherlands, Indo-Singapore, Indo-US and Indo-UK DTAAAs, following items are excluded from the definition of FTS -

- (a) Services inextricably linked to sale of properties (other than copyright, patents, design, secret formula etc.)
- (b) Services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic.
- (c) Teaching in or by educational institutions.
- (d) Services for private use of individual payers.
- (e) Payment to employee of a payer or to any individual or firm for Independent Personal Services.

FTS Article of each DTAA needs to be examined to ascertain whether a particular payment

⁵¹ Engineering Analysis Centre of Excellence Ltd v CIT [2021] 125 taxmann.com 42 (SC).

constitutes FTS or not.

Some Judicial Precedents⁵²

In the case of **Cargo Community Network Pte Ltd (2007) 289 ITR 355 (AAR)** and in the case of **ACIT V/s. Paradigm Geophysical Pvt Ltd (2008) 25 SOT 94 (Del)**, it has been held that Article 12 prevails over Article 7 and Article 14, unless specifically excluded.

In the following cases, it has been held that royalty has been held to be taxable only when **there is a payment**; it is in the nature of royalties as defined under art. 12(3); royalty income has accrued in the Source State and the royalty income is not attributable to the PE / Fixed base of non-resident and no business is carried on through a PE/ fixed base: -

- (a) National Organic Chemical Industries Ltd [(2006) 96 TTJ 765 (Mum)]
- (b) Uhde GmbH [(1996) 54 TTJ 355 (Mum)]
- (c) Siemens Aktiengesellschaft [2012-TII-59-HC-MUM-INTL]

In the case of **Intertek Testing Services India (P) Ltd [(2008) 307 ITR 418 (AAR)]**, it has been held that revenue cannot allege the lack of ‘**beneficial ownership**’ on the basis of mere assumptions.

In the context of **definition of royalty under section 9(1)(vi) of the Act, vis-à-vis Article 12 of most of the DTAAs**, there have been various decisions. The following decisions provide that under section 9(1)(vi), any consideration for transfer of all or any rights in respect of patent, invention, model, design, secret formula, process, trademark or similar property falls within its definition; whereas under Article 12, the payment for use of such assets would fall within the definition of royalties: -

- (a) Swadeshi Polytex Ltd V/s. ITO [(1991) 38 ITD 328 (Del).
- (b) DCM Ltd [(1989) 29 ITD 123 (Del)]
- (c) Reliance Industries Ltd [(2011) 43 SOT 506 (Mum)]
- (d) CIT V/s. Samsung Electronics Co Ltd [(2011) 203 Taxman 477 (Kar)]

However, the contrary view also could not be ruled out from the gamut of royalty taxation. The following are the contrary Court decisions:

- (a) Airports Authority of India [(2008) 304 ITR 216 (AAR)]
- (b) ISRO Satellite Centre [(2008) 307 ITR 59 (AAR)]
- (c) Citrix Systems Asia Pacific Pty Ltd [(2012) 343 ITR 1 (AAR)]

3.13.13 Capital Gains

- **Concept**

⁵² The Law and Practice of Tax Treaties – An Indian Perspective by Nilesh Modi – Second Edition

Profit or gain arising from transfer of a capital asset is generally regarded as “Capital Gain”.

Under the OECD and the UN Model Treaties, the general rule is that Capital Gains from alienation of property are taxed only in state of Residence of the alienator. However, a different treatment is accorded for certain special types of Capital Gains. Capital Gain is dealt with in Article 13 of both OECD as well as the UN Model conventions. A brief outline of Article 13 is given in Table as follows:

Para No	Model	Convention
1.	UN & OECD	Immovable property – may be taxed in the state where the property is situated
2.	UN & OECD	Movable property forming part of a PE or Fixed Base – may be taxed in the state where the PE or Fixed Base is situated.
3.	UN & OECD	Ships / aircrafts – shall be taxed only in the state in which “Place of Effective Management” (POEM) is situated.
4.	UN	Shares in a company whose property principally consists of immovable property may be taxed in the state where immovable property is situated.
5.	UN	Other shares, representing a participation in excess of specified threshold, may be taxed in the state where the company is Resident.
6.	UN & OECD	Any other property shall be taxed only in the state of Residence of the alienator.
7.	UN	Gain derived by a resident of a contracting state from the alienation of shares of a company or comparable interest in an entity may be taxable in other contracting state if certain conditions are satisfied
8.	UN	Gain derived by a resident of a contracting state from the alienation of any property other than referred in para 1-7 shall be taxable only in the state in which alienator is a resident

Some salient aspects of Article 13 in general and each of the paragraphs thereof are briefly discussed below:

- **General**

- If a state does not levy tax on capital gains, this article cannot be construed as giving that state the right to tax capital gains.
- As a general rule, mere appreciation in value of an asset does not give rise to capital gains and is not covered by this Article unless it is considered as capital gains under the domestic law.
- The Model Treaties do not define “Capital Gains.” The term “Alienation” seems to be wide enough to cover sale, exchange, partial alienation and expropriation, sale of a right, gift and even transmission of property on death.
- The Article does not provide how to compute capital gains. This is left to the domestic tax law.
- The Article is not intended to apply to prizes in a lottery or to premia attached to bonds or debentures (Para 19 of the OECD Commentary on Article 13).

- **Paragraph 1 (UN & OECD Model)**

Capital Gains on alienation of immovable property “may be taxed” in the state of situs. It appears that this paragraph does not give the state of situs the exclusive right to tax. The state of Residence may also tax the said income. The alienator will, of course, be entitled to eliminate double taxation in accordance with the special Article dealing with “Methods of elimination of double taxation”.

This view is also supported by the fact that the UN Model, in paragraph 3 (Ship/Aircraft) and Paragraph 6 (any other property) states that capital gains “shall be taxed only” in a particular state.

However, a contrary view is not completely ruled out. The Madras Special Bench of the Income Tax Appellate Tribunal in the case of **P.V.A.L. Kulandagan Chettiar V/s. ITO 3 ITD 426** faced the question of interpreting the phrase “may be taxed in Malaysia” in the context of Article 6 of the Indo–Malaysia Treaty.

The Tribunal observed that:

“Article 6 empowers Malaysia to tax the income from properties. Considering that the object of the agreement is avoidance of double taxation and not relief from double taxation which is well-known expression, does not find a place in the preamble, the necessary interpretation should be that it is only Malaysia that can levy the tax. If India can also levy tax, it will only frustrate the object of avoidance of double taxation for which the agreement was made. Even without the agreement, Malaysia can tax the property income which arises in Malaysia to the assessee who will be a non-resident as far as Malaysia is concerned. So, the object cannot be to confer Malaysia with power to tax which power it already possesses. The object can only be to take away or restrict the existing power of Indian Government to tax income from such properties, so that double taxation can be avoided”.

In case of **CIT vs. Vr. S.R.M. Firm (Madras) 208 ITR 400** the Madras High Court dealt with the interpretation of the phrase “may be taxed in Malaysia” in the context of Article 6 of the Indo – Malaysian Treaty. Here again, the Court observed that the phrase “may be taxed” does not give the other state right to tax on an automatic basis.

The Court observed *“The contention on behalf of the Revenue that wherever the enabling words such as “may be taxed” are used, there is no prohibition or embargo upon the authorities exercising powers under the Income Tax Act, 1961, from assessing the category or class of income concerned cannot be countenanced as of substance or merit. As rightly pointed out on behalf of the assessee, when referring to an obvious position such enabling form of language has been liberally used and the same cannot be taken advantage of by the Revenue to claim for it a right to bring to assessment the income covered by such clauses in the agreement, and that the mandatory form of language has been used only where there is room or scope for doubt or more than one view is possible, by identifying and fixing the position and placing it beyond doubt”*.

The Court even refused to accept the Department’s reliance on the OECD commentaries as model convention as it found that the content and purport of the articles in the model convention and those in the treaty with Malaysia differ.

The Court gave weightage to the real purport of the Treaty and did not go on the basis of the OECD commentary.

The Supreme Court has upheld the above High Court decision in the case of *Vr. S.R.M Firm’s (supra) in C.I.T. V/s. P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654 (SC)*.

Amendment / Clarification of intent by way of issuing Notification No. 91 of 2008 dated 28th August, 2008

The said notification now clarifies that wherever the expression “may be taxed” is used in relation to income of Indian resident in other country, such income shall be included in the total income chargeable to tax in India. The exact wordings of the Notification are being reproduced here under:-

“In exercise of the powers conferred by sub-section (3) of section 90 of the Income-tax Act, 1961 (43 of 1961), the Central Government hereby notifies that 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 Limited V/s. ACIT (I.T.A No. 2428 / Mum / 2007), (I.T.A No. 2442 / Mum / 2007)

The Mumbai Tribunal in this case has held that the phrase “may be taxed” used in India-Oman and India-Qatar tax treaties denotes that the source country has a right to tax without affecting

the resident country's right to tax. Accordingly, the income earned in the source country shall be included in the taxpayer's total income chargeable to tax in India in accordance with the provisions of Act, and relief shall be granted in accordance with the methods provided under the tax treaties. The notification has clarified the phrase "may be taxed", does not impose any kind of tax liability and it merely clarifies the particular expression used in a tax treaty hence it is clarificatory in nature. Accordingly, the notification shall have a retrospective effect from A.Y 2004-05.

- **Paragraph 2 (UN and OECD Models)**

Gains from alienation of "movable property" forming part of a permanent Establishment (PE) or a Fixed Base (F.B.) may be taxed in the state in which PE or FB is situated. This rule corresponds to Article 7 dealing with Business Profits. The connotation of the phrase "may be taxed" will now be as per the notification issued by the CBDT. (Refer Essar Oil Limited case supra). "Movable Property" means all property other than "immovable property" which is dealt with in paragraph 1. It includes also incorporeal property such as goodwill, licenses, etc. If the whole of the PE is alienated, then the rule applies to such gains which are deemed to result from alienation of movable property forming part of the business property of the PE.

- **Paragraph 3 (UN and OECD Models)**

Unlike paragraphs 1 & 2, this paragraph grants exclusive right to tax gains from alienation of ships, aircrafts, etc. to the State in which the place of effective management of the enterprise is situated.

This Article is in line with Article 8 which deals with taxation of shipping/aircraft enterprises.

- **Paragraph 4 (UN Model)**

Gain from alienation of shares of a company, the property of which consists principally of immovable property is taxed in the State of situs. It could be relatively easy to avoid tax on such gains through incorporation of a company to hold such property. This paragraph is designed to prevent such tax avoidance.

OECD Model does not have this paragraph. Also, paragraph 1, which deals only with immovable property, does not deal with shares of companies.

This paragraph would apply irrespective of whether or not the company is a resident of the Situs State.

- **Paragraph 5 (UN Model)**

This paragraph lays down that the State of which the company is a resident has the jurisdiction to tax gains on alienation of shares in such company.

This jurisdiction applies irrespective of whether the sale occurred within or outside the State. The right to tax, however, is limited to sale of substantial participation.

- **Paragraph 6 (UN Model) / Paragraph 5 (OECD Model)**

This paragraph lays down the general rule of taxation of capital gains. According to this

paragraph, only the State of residence of the alienator has the exclusive right to tax all capital gains, other than capital gains dealt with in earlier paragraphs.

The above is an outline of what the UN and OECD Model Conventions provide. The treaties with different countries do have variations from the above models, and for application in real life situation, the relevant country Treaty will have to be referred to.

Some Judicial Precedents⁵³

In the case of **DLJMB Mauritius Investment Co [(1997) 228 ITR 268 (AAR)]**, the AAR held that Article 13 applies to all capital gains, irrespective of period of holding and including capital gains due to [depreciation of national currency]⁵⁴.

In the case of **Vodafone International Holding BV v/s. UOI [(2012) 341 ITR 1 (SC)]**, it was held that the character of the transaction as alienation cannot be altered by (i) form of consideration (ii) payment in installments or that (iii) the payment is dependent upon an event which is contingent.

3.13.14 Independent Personal Services

Provisions relating to Independent Personal Services are usually covered under Article 14 of a Treaty though this Article was deleted by the 2000 Update of the OECD Model.

- **Meaning**

Services rendered by professionals like physicians, accountants, lawyers, artists, engineers, architects etc. are covered by this Article. It also includes any independent scientific, literary, artistic, educational or teaching activity.

Any activity of independent nature involving technical/professional skills are generally covered by this Article. However, income of entertainers and athletes, fees for technical services, are dealt in separate Articles in a Treaty.

- **Taxability**

Income from services of above nature would generally be taxed in the State of which the recipient is a Resident.

For example, a surgeon, Dr. Bill - resident of USA visits India for an operation. Income from this operation would be taxable in USA.

However, the State of Source (India, in the given example) may also tax such income if, either Mr. Bill has a clinic/nursing home in India through which he performs this operation or he visits India frequently for such operations and his total stay in India exceeds 90 days in a financial year (183 days in various other DTAAAs).

Some DTAAAs provide one more condition whereby the State of Source reserves the right to tax

⁵³ The Law and Practice of Tax Treaties – An Indian Perspective by Nilesh Modi – Second Edition

⁵⁴ First proviso to section 48 of the Income-tax Act read with Income-tax Rules

and that is, if remuneration is paid by a resident of the State of Source or is borne by a Permanent Establishment (PE) or a Fixed Base situated in that State and such remuneration exceeds a particular sum in the financial year. (This sum or amount is negotiated bilaterally). For example, Indo-Canadian treaty provides \$ 2,500 as such sum.

- **Partnerships Firms**

Though essentially this Article covers services rendered by individuals, in case of Indo-US and Indo-UK treaties, services rendered by partnership firms also are covered.

In case of Indo-UK treaty, there is one more deeming provision whereby even if one of the partners is present in the State of Source, the other partners are also deemed to be present there. The implication of this provision is that, in calculating the number of days of presence of the firm in the State of Source, stay of any of the partners needs to be aggregated.

- **Deletion of Article 14 from OECD Model**

Article 14 dealing with Independent Personal Services, has been deleted from the OECD Model in January, 2000. This deletion reflects the fact that there were no intended differences between the concepts of “PE” as used in Article 7 and “fixed base” as under in Article 14. The effect of this deletion is that income from professional services, as per the revised OECD Model, is now taxable under Article 7. In practice, however, the effect will be seen only in cases where a particular treaty is amended by mutual consent so as to fall in line with the revised OECD Model.

3.13.15 Entertainers / Athletes

- **Meaning**

Income earned by entertainers such as a theatre, motion picture, radio or television artiste or a musician, or an athlete is covered by this Article.

- **Taxability**

Income of the above nature is taxable in the state wherein such personal activities are performed. Even if the income accrues to the organizer who is different from the entertainer or artiste, it will be taxable in the State of Source.

For example, Mr. Nipun Kumar earns from stage shows in UK. This income will be taxable in the UK. The position would remain same even if the show was organized by a local organizer.

- **Exceptions**

Some treaties provide an exception to this rule and that is when the visit of such entertainer or an athlete is supported wholly or substantially from the public funds of his home country, then such income would be taxable in his home country, i.e., country of residence of the artiste/entertainer.

Some treaties even provide that income would be taxed by the State of Source only if it exceeds certain amount or activities performed exceed certain number of days. For example, \$ 1,500 or

its equivalent in Indian rupees will be taxable in case of Indo-USA treaty and 15 days in case of Indo-UAR (Egypt) treaty. Therefore, one needs to look at the provisions of a particular DTAA when applying the same.

3.13.16 Dependent Personal Services

Provisions relating to Dependent Personal Services are usually covered under Article 15 of a Treaty.

- **Meaning**

Dependent Personal Services cover income from employment, namely, salaries, wages and other similar remuneration except the following:-

- (a) Directors' fees and remuneration of top level managerial personnel;
- (b) Provision for social security payments and;
- (c) Remuneration and Pension in respect of Government services and private pensions;

All the above types (a, b and c) of income are usually covered by separate Articles under a DTAA.

- **Taxability**

Income from dependent personal services covered by this Article is generally taxable in the State of Source (i.e., the state where employment is exercised). However, it will be taxable only in the State of Residence if the following conditions are fulfilled.

- (a) The recipient is present in the State of Source for less than 183 days in the aggregate in a relevant fiscal year;
- (b) The remuneration is paid by or, on behalf of an employer who is not a resident of the State of Source; and
- (c) The remuneration is not borne by a Permanent Establishment (PE) or a Fixed Base which the employer has in the State of Source.

- **Remuneration aboard a Ship or Aircraft**

Remuneration derived aboard a ship or an aircraft operated in international traffic may be taxed in the state where the Place of Effective Management of the concerned enterprises is situated.

However, some treaties provide for taxability in the State where the enterprise carrying on such activity is Resident (Indo-USA Treaty, India-UK Treaty).

- **Example**

Mr. Dev, a software engineer, employed by an Indian software company leaves India (for the first time) on a deputation to Belgium, on 1st Nov. 2002. He is paid remuneration of INR 15,000 p.m. in India. On 1st Jan. 2003 he leaves the Indian company and takes up employment with a company in Belgium, and he is paid remuneration in Belgium. What will be his tax liability?

Mr. Dev is present in India for more than 183 days in the financial year 2002-03. Hence, he is

resident of India during F.Y. 2002-03. As he is leaving India for the first time, he will be resident and ordinarily resident. Accordingly, his world income is taxable in India; i.e., even the salary received from the company in Belgium. However, due to provisions of DTAA with Belgium, Belgium has taxing rights on remuneration received by Mr. Dev for employment exercised in Belgium. India will be required to provide credit for Belgian taxes.

3.13.17 Non-Discrimination Provision (NDP)

- **Types of NDP**

As the title suggests, this Article is intended to prohibit discriminating taxation of two sets of income earners who are otherwise considered as being “in the same circumstances”.

The Non-Discrimination Provisions (NDP) in this Article are broadly classified in Double Taxation Conventions into four categories -

- (a) The Nationality NDP;
- (b) The Permanent Establishment (PE) NDP;
- (c) The Deduction NDP; and
- (d) The Ownership NDP.

Each of these is discussed briefly as follows -

- **Nationality NDP**

Article 24(1) of the OECD Model Convention states that nationals of State ‘A’ shall not be subjected in State ‘B’ to taxation or other connected requirement which is other or more burdensome than that to which nationals of State ‘B’, in the same circumstances, are subjected.

For example, if nationals of State ‘B’ are subjected to tax at the rate of 20% in State ‘B’, then nationals of State ‘A’ cannot be subjected to tax in State ‘B’ at a rate higher than 20%, provided the nationals of both the states are “in the same circumstances”. Notably, a resident national cannot be considered “in the same circumstances” as a non-resident.

Illustration

- Mr. Shah is an Indian National and Resident in India.
- Mr. Sam is a US National and Resident in India
- Mr. Smith is a UK National and a non-resident in India

Here, in so far as India is concerned:

- Mr. Shah and Mr. Sam are “in the same circumstances” (because both are Residents)
- Mr. Shah and Mr. Smith are NOT “in the same circumstances” (Because one is a resident in India while the other is not).

Thus, as per Article 24(1), India cannot subject Mr. Sam to taxation or other connected requirement which is other or more burdensome than the taxation and other connected requirements to which Mr. Shah is subjected. Mr. Smith may, however, be subjected to taxation

which is other or more burdensome than that to which Mr. Shah is subjected.

The OECD commentary elaborates on the meaning of the term “other or more burdensome”. When a tax is imposed on nationals and foreigners who are in the same circumstances, it must be in the same form as regards -

- Basis of charge;
- Method of assessment;
- Rate of tax;
- Formalities (like returns, payments, prescribed time, etc.)

However, there is no bar against providing more favourable treatment to foreigners compared with nationals in the same circumstances.

This Article talks of non-discrimination amongst “nationals of different states”. The word “national” as defined in the Model Convention, covers within its scope not only individuals possessing nationality of a state but also legal persons, partnerships, associations deriving their status as such from the local laws of respective states.

• **Permanent Establishment (PE) NDP**

Article 24(3) of the OECD Model Convention states that a PE of an Enterprise of State ‘A’ in State ‘B’ shall not be subjected in State ‘B’ to taxation less favourable than the taxation levied on an enterprise of State ‘B’ carrying on the same activities.

The OECD Model, however, clarifies that State ‘B’ is not bound to grant to residents of State ‘A’, any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. This is probably because the person to whom the PE belongs is likely to enjoy these benefits in his home state and to accord the same in the state of PE may result in double benefit.

Unlike Article 24(1), in this case, the comparison is not to be made with an enterprise “in the same condition”. The requirement is that the two enterprises should be carrying on the same activities.

The OECD commentary suggests that a PE of a foreign enterprise must be accorded equal treatment as applicable to a local enterprise in respect of:

- deduction of trading expenses including appropriate portion of Head Office expenses ;
- depreciation allowance or reserves for investments, etc.;
- carry forward of losses;
- scale or rates of tax (Para 37 of OECD commentary)

It may, however, be noted that in a number of treaties, which India has signed, it has been expressly provided that difference in rate of tax will not be considered as a case of discrimination.

Interestingly, the Finance Act, 2001 has introduced an Explanation to Section 90 of the Act with retrospective effect from April 1, 1962, to clarify that the charge of tax in respect of a foreign company at the rate higher than the rate applicable to domestic company shall **not** be regarded as less favourable charge.

One wonders as to how should those tax treaties which do not provide that difference in rate of tax will not be considered as a case of discrimination should now be interpreted. One also wonders as to whether such a provision in the domestic law amounts to a unilateral treaty override of all such treaties.

- **Deduction NDP**

Article 24(4) provides, broadly, that where a resident of State 'A' pays interest, royalties or other disbursements to a resident of State 'B', then, the rules for deductibility of such payments in computing taxable profits of the resident of State 'A' should be the same as are applicable in respect of the payments made to another resident of State 'A' itself.⁵⁵

- **Ownership NDP**

Article 24(5) provides that an Enterprise in State 'A' which is wholly or partly owned or controlled, directly or indirectly by residents of State 'B' should not be subjected in State 'A' to any taxation or connected requirement which is other or more burdensome than taxation or connected requirement to which another Enterprise in State 'A', in the same circumstance, is subjected to.

Here, the comparison is between two enterprises, both situated in State 'A', but one is owned or controlled by residents of State 'B' while the other is owned or controlled by residents of State 'A' itself.

Article 24(6) applies to taxes of every kind and description and is not restricted by the definition of taxes covered under provisions of Article 2 of DTAA

3.13.18 Mutual Agreement Procedure (MAP)

- **What is MAP?**

As the name suggests, MAP is a special procedure provided for in the tax treaties, whereby disputes relating to applicability of tax treaty provisions are settled by "mutual agreement" between the Competent Authorities of the Contracting States. Insofar as India is concerned, the Competent Authority is:

*The Joint Secretary,
Foreign Tax & Tax Research Division,
Central Board of Direct Taxes,
Department of Revenue,
Ministry of Finance,*

⁵⁵ Except where transfer pricing provisions in paragraph 1 of Article 9, paragraph 6 of Article 11 or paragraph of Article 12 apply

New Delhi.

- **Types of problems solved through MAP**

This procedure is found in Article 25 of the OECD & UN Model Conventions. The provisions for settlement of disputes can be broadly classified into three categories:

- (a) **Specific case provision:** Where a resident of a State considers that actions of one or both the States result or will result in taxation not in accordance with the provisions of the Treaty, he may make a reference to the Competent Authority of his State to intervene in the matter.
- (b) **Interpretative provision:** Difficulties relating to interpretation or application of the treaty may also be referred to the Competent Authority.
- (c) **Legislative Provision:** There could be situations which result in double taxation but which are not covered by the provisions of the existing treaty. In such cases, the Competent Authority may be approached with a petition to eliminate double taxation in situations not provided for in the treaty.
- (d) **Cases specifically agreed to be referred to competent authorities:** Currently various jurisdictions as part of the BEPS initiative of the OECD, have signed the Multilateral Instrument (MLI). Article 16 of the MLI as part of dispute resolution provides for MAP as a minimum standard to be adopted by the parties. However, parties can express reservation if their existing Treaties have a MAP procedure and same has been notified in the Covered Tax Agreement (CTA). Certain areas where it has been agreed to get into MAP under the MLI include, Paragraph 1 of Article 4 of the MLI which provides that, where a person other than an individual is a resident of more than one contracting jurisdiction (i.e. cases of dual residency), the residential status of such person shall be determined mutually by the competent authorities of these contracting jurisdictions having regard to various relevant factors.

- **How does MAP work?**

- A taxpayer may invoke one or more of the above provisions and present his case to the Competent Authority of his State of residence or nationality, as the case may be.
- Such presentation should be made within the time specified in the concerned treaty. The Model Conventions prescribe a three years' time limit i.e. three years from the first notification of the action resulting in disputed taxation.
- In case, the objection of the taxpayer appears to be justified and the Competent Authority is not itself able to arrive at a satisfactory solution, such Competent Authority shall endeavor to resolve the case by mutual agreement with the Competent Authority of the other state.
- The Competent Authorities may communicate with each other directly for the purpose of reaching an agreement and the decision is communicated to the taxpayer.

— The taxpayer has the option to accept or reject the MAP resolution.

- **Actual or probable taxation - both covered.**

A taxpayer may apply to the Competent Authority where he considers that the action of the tax authorities has resulted or “will result” in taxation not in accordance with the treaty. Thus, even probable tax demand can be settled through this procedure. For example, the tax department has rejected to grant a No Objection Certificate for permitting a remittance without deduction of tax at source. Such rejection, though does not per se result in taxation, the applicant may invoke MAP on the ground that such rejection “will result” in taxation which according to him, would be “not in accordance with” the treaty.

- **MAP vs. other remedies under domestic law**

The MAP can be invoked without depriving a taxpayer of the ordinary legal remedies available under the domestic law. Thus, while appeals, revisions petitions, etc. can be filed under the domestic law, MAP can be invoked concurrently.

- **Duties of the Competent Authority**

The Competent Authority must endeavor to resolve the problem but is not duty bound always to arrive at an agreement.

- **Time Limits**

The application must be made, generally, within three years from the action resulting in disputed taxation. However, there is no prescribed time limit for the Competent Authority for arriving at an agreement. Indeed, they may not necessarily always reach an agreement. But, once the agreement is reached, the same must be implemented notwithstanding any time limits in the domestic law.

- **Binding effect of MAP Agreement**

If a Court/Tribunal case is pending, whether the agreement reached under MAP could have a binding effect, is a vexed question. The agreement reached would generally, be binding on the Administrative Authorities. (In cases where there are contrary binding court rulings, the binding effect on the Administrative Authorities is, again, a vexed question) The OECD Model Convention commentaries suggest that the implementation of a Mutual Agreement should be made subject to:

- (a) the acceptance by the taxpayer, and
- (b) the taxpayer’s withdrawal of pending litigations on the points settled through MAP

By following this procedure, it is ensured that the MAP agreement, once implemented, becomes binding on all concerned.

- **Rules relating to Mutual Agreement Procedure in India**

All the DTAA contain an Article on MAP. Earlier, India did not have the formal procedure to invoke MAP. However, the CBDT had prescribed Rules viz. Rules 44G and 44H vide Income-tax (Amendment) Rules, 2003, notified on 6th February, 2003. Further, the said rules have now

been substituted by Income tax Rules, 2020 and combined into a single Rule 44G, with effect from 6 May 2021, as under:

Rule 44G provides as follows :

(1) Where an assessee, being a resident of India, is aggrieved by any action of the tax authorities of any country or specified territory outside India for the reason that, according to him, such action is not in accordance with the terms of agreement with such other country or specified territory, he may make an application to the Competent Authority in India seeking to invoke the mutual agreement procedure, if provided in such agreement, in Form No. 34F.

(2) Where a reference has been received from the competent authority of any country or specified territory outside India under any agreement with that country or specified territory with regard to any action taken by any income-tax authority in India or by the tax authorities of such country or specified territory, the Competent Authority in India shall convey his acceptance or otherwise for taking up the reference under mutual agreement procedure to the competent authority of the other country or specified territory.

(3) The Competent Authority in India shall, with regard to the issues contained in Form No. 34F or in the reference from the competent authority of a country or specified territory outside India, call for the relevant records and additional document from the income-tax authorities or the assessee or his authorised representative in India, or have a discussion with such authorities or assessee or representative, to understand the actions taken by the income-tax authorities in India or outside that are not in accordance with the terms of the agreements between India and the other country or specified territory.

(4) The Competent Authority in India shall endeavour to arrive at a mutually agreeable resolution of the tax disputes, arising from such actions of the income-tax authorities, in accordance with the agreement between India and the other country or specified territory within an average time period of twenty-four months.

(5) In case the mutual agreement procedure is invoked on account of action taken by any income-tax authority in India, the resolution arrived at under sub-rule (4) in a previous year shall not result in decreasing the income or increasing the loss, as the case may be, of the assessee in India, as declared by him in the return of income of the said year.

(6) If a resolution is arrived at under sub-rule (4) between the Competent Authority in India and that of the other country or specified territory, the same shall be communicated in writing to the assessee.

(7) The assessee shall communicate his acceptance or non-acceptance of the resolution in writing to the Competent Authority in India within thirty days of receipt of the communication under sub-rule (6).

(8) The assessee's acceptance of the resolution shall be accompanied by proof of withdrawal of appeal, if any, pending on the issues that were the subject matter of the resolution arrived at under sub-rule (4).

(9) On receipt of acceptance under sub-rule (7), the Competent Authority in India shall communicate the resolution arrived at under sub-rule (4) and the acceptance by the assessee alongwith proof of withdrawal of appeal, if any, submitted by the assessee under sub-rule (8), to the Principal Chief Commissioner or the Chief Commissioner or the Principal Director General or Director General, as the case may be, who in turn shall forward it to the Assessing Officer.

(10) On receipt of communication under sub-rule (9), the Assessing Officer shall give effect to the resolution arrived at under sub-rule (4), by an order in writing, within one month from the end of the month in which the communication was received by him and intimate the assessee about the tax payable determined by him, if any.

(11) The assessee shall pay the tax as determined under sub-rule (10) within the time allowed by the Assessing Officer and shall submit the proof of payment of taxes to the Assessing officer who shall then proceed to withdraw the pending appeal, if any, pertaining to subject matter of the resolution under sub-rule (4), which were filed by the Assessing Officer or the Principal Commissioner or Commissioner or any other income-tax authority

(12) A copy of the order under sub-rule (10), shall be sent to the Competent Authority in India and to the assessee.

(13) The amount of tax, interest or penalty already determined shall be adjusted in accordance with the resolution arrived at under sub-rule (4) and in the manner provided under the Act or the rules made thereunder to the extent that such manner is not contrary to the resolution arrived at.

Explanation. - For the purposes of this rule, the "Competent Authority in India" shall mean an officer authorised by the Central Government for the purposes of discharging the functions as such.

3.13.19 Entry into Force

When does a treaty become effective?

In the text of a typical notification giving effect to a tax treaty, generally, following dates are found:

- (a) The date of Agreement
- (b) The date of exchange of instruments of ratification; and
- (c) The date of notification

Interestingly, a tax treaty generally does not come into effect from any of the above three dates. The date from which a treaty comes into effect is provided in a separate Article, generally entitled "Entry into Force" (EIF). In the UN and OECD Model conventions, the EIF Article appears as Article 29 and Article 30 respectively.

The chronology is as follows:

- An agreement is signed by the two countries on a date mentioned therein;

- The EIF Article generally requires that each contracting state shall:
 - complete all legal procedures required by its local laws; and
 - issue notification to the other State of such completion. This is also referred to as an instrument of ratification.
- The Agreement generally enters into force on the date of the latter of the aforesaid notifications / instruments of ratifications;
- The Central Government then directs that the provision of the treaty shall be given effect to in the Union of India.

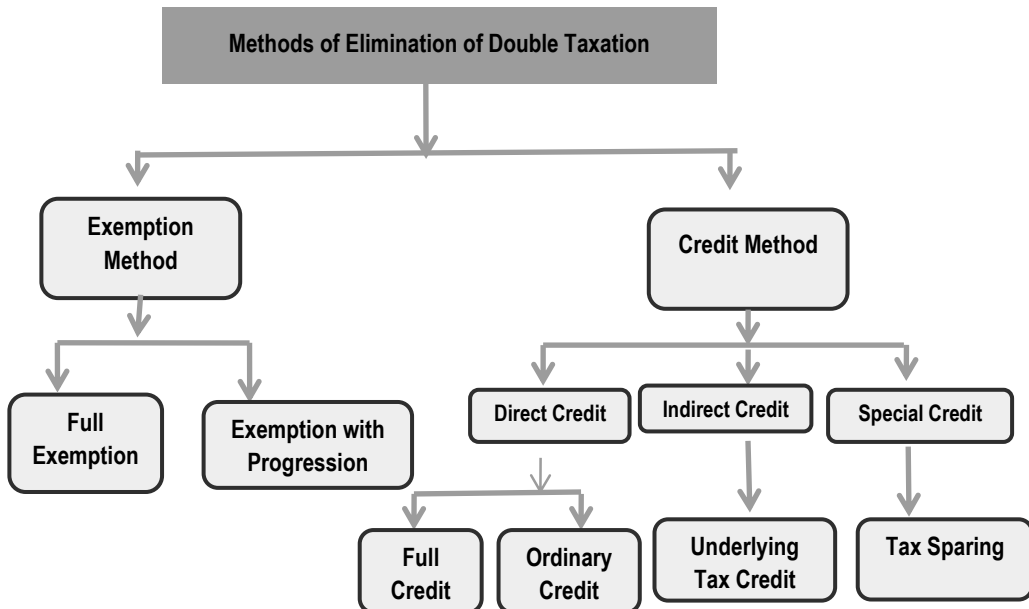
The dates given at (a), (b), & (c) above corresponds to the above sequence of events. However, till this stage, the treaty, generally, does not become effective.

As per EIF Article, generally, a treaty becomes effective from the 1st day of the Financial Year next following the date of the last of the two notifications exchanged by the two countries. However, in borderline cases, to determine whether a transaction effected in a given period is or is not covered by the treaty, it will always be advisable to check:

- (a) the EIF Article ; and
- (b) the definition of Fiscal Year / Financial Year.

3.13.20 Methods of elimination of double taxation

Summary



Many a times, a situation arises whereby same income is taxed twice, i.e. in the State of

Residence as well as State of Source. In order to eliminate double taxation, two methods are used. They are:

- (a) Exemption Method and
- (b) Credit Method

- **Exemption Method**

- (i) **Full Exemption Method**

Under this method, income earned in the State of Source is fully exempt in the State of Residence.

- (ii) **Exemption with Progression**

Under this method, income from State of Source is considered by the State of Residence only for the rate purpose.

For example, an Indian Company has earned income from Indian sources of INR 80 Lacs. Income from foreign sources (relief available as per exemption with progression method) is INR 25 Lacs. As per the provisions of Act, in India, an additional surcharge of seven percent (7%) is levied in addition to normal income-tax liability if the total income exceeds one crore **and at the rate of 12% if income exceeds 10 Crores**⁵⁶. Therefore, in the present case, total income for rate purpose only will exceed one crore and accordingly, effective rate for tax would be after considering the additional surcharge of seven percent. However, the income on which the effective rate (inclusive of surcharge) would apply will be INR 80 Lacs only.

- **Credit Method**

- (i) **Full Credit**

Total tax paid in the State of Source is allowed as credit against tax payable in the State of Residence.

- (ii) **Ordinary Credit**

State of Residence allows credit of tax paid in the state of Source restricted to that part of income tax which is attributable to the income taxable in the state of Residence.

- **Method of Tax Sparing**

State of Residence allows credit for deemed tax paid on income which is otherwise exempt from tax in the State of Source.

- **Example**

Let us understand these methods with the help of an example -

⁵⁶ As per Finance Act 2019

1.80 International Tax — Practice

Income derived by 'A' from State of Residence	INR 1,00,000/-
Income derived by 'A' from State of Source	INR 50,000/-
	<hr/>
Total Income of A	INR 1,50,000/-
	=====

Tax Rates are:

State of Source 40% flat rate

State of Residence

Up to INR1,00,000/- 30%

Between 1 Lac and 2 Lacs 35%

Tax paid in State of Source on INR 50,000 = INR 20,000/-

(@ 40% on INR 50,000/-)

Tax Paid in State of Residence = INR 47,500/-

on INR 1,50,000.00 (@ slab basis)

Tax liability in State of Residence under various Methods of Elimination of Double Taxation is shown hereunder -

(i) Full Exemption Method

State of Residence levies tax only on domestic income i.e. tax on INR 1,00,000/- @ 30% = INR 30,000/-. It does not levy any tax on income earned in the state of Source. (i.e. on INR 50,000 in this case). In other words, it exempts income earned in the state of Source from its tax. Tax is levied only by the State of Source in respect of income earned therein. As a result, double taxation of income is automatically eliminated.

(ii) Exemption with Progression

Domestic income of INR 1,00,000/- will be taxed at the rate applicable to total Income. i.e. Tax on INR 1,00,000/- @ 35% (rate applicable to slab of INR 1,50,000/-) = INR 35,000/-. This offers partial exemption compared to the Full Exemption Method.

(iii) Full Credit

Tax Payable on total income in the state of Residence will be as below :

INR 1,50,000/- on slab basis INR 47,500/-

Less: Credit for tax paid in the state of Source INR 20,000/-

Tax Liability in the state of Residence INR 27,500/-

(iv) Ordinary Credit

At first, tax liability on total income is worked out in the state of Residence (i.e. on INR 1,50,000/- on slab basis) and then the credit is given for the tax paid in the state of Source. However, such

credit is restricted to the amount of tax attributable to the income from the state of Source, i.e. 35% of INR 50,000/- = INR 17,500/-

Tax payable on INR 1,50,000/- (slab basis)	INR 47,500/-
Less: Tax paid in the state of Source	INR 20,000/-
Maximum Deduction Restricted to (35% on INR 50,000/-)	INR 17,500/-
Tax Liability	INR 30,000/- =====

(v) Tax Sparing

Now, let us assume for a moment that Mr. A has tax-free income of INR 30,000/- in the state of Source. In this situation a deemed tax credit for INR 12,000/- (being 40% INR 30,000/-) will be granted by the state of Residence. Usually, DTAA prescribes the exact nature of such tax-free income and/or relevant provisions of the domestic law, covered by this method.

For example, Indo-Japan Treaty provides that tax on interest income is deemed to be paid in India on certain interest income which is otherwise fully exempt under section 10(15)(iv) and also on profits of industrial undertakings covered by section 80-I.

3.13.21 Credit for Tax on Dividend

Many treaties provide special treatment for credit in respect of tax paid on profits out of which dividend is declared. Where a company Resident in India declares dividend, and a foreign company receiving dividend either directly or indirectly holds 10/25 percent of the voting power or issued capital of the Indian company, then in such situation the foreign company receiving dividend gets credit for tax paid on profits out of which dividend is declared. The requirement for percentage of holding differs from treaty to treaty.

Article on Elimination of Double Taxation assumes great significance as it is the central point of any Treaty. Wordings of Article 23 [Article on elimination of Double Taxation] vary from Treaty to Treaty. Therefore, one needs to closely scrutinize the wordings of Article 23 of the DTAA under examination. Treaties generally use combination of various methods for granting relief from double taxation. It is also a powerful tool for the purpose of Tax Planning. In fact, it serves well the ultimate objective of the treaty, namely, overall minimization of tax burden or avoidance of same income being taxed by two countries.

Notes:

1. In respect of full exemption method, income is taxed only in Source Country.
2. Some countries give Exemption with Progression partially. For example, in case of treaty with Germany, Indian income is considered in Germany only for rate purposes, whereas ordinary credit is available in India in respect of tax paid in Germany on German income.

Most treaties provide that where a particular income is taxable only in one State by virtue of provisions of the treaty, then the same income is considered by the other State only for rate purposes.

3. Ordinary credit is given by many countries in respect of income which is taxed in both States.

Some Judicial Precedents

In the case of **Mideast India Ltd [(2009) 28 SOT 395 (Del)]**, it was held that in order to apply Article 23, there has to be double taxation in first place before the issue of elimination of double taxation can arise. Article 23 applies only to State R and not to State S [**Bombay Burmah Trading Corpn Ltd (2002) 82 ITD 531 (Mum)**].

In the case of **Syed Iftikhar Gilani v/s. ACIT [2008-TIOL-92-ITAT-DEL]** and **Sanofi Pasteur Holding SA v/s. Department of Revenue, Ministry of Finance (2013) 30 taxmann.com 222 (Andhra Pradesh)**, it was held that tax credit is allowable only if the tax is paid in accordance with the provisions of the tax treaty. Therefore, if a taxpayer say, Mr. X has paid tax on income in State S which is not in accordance with the provisions of the tax treaty, then unless otherwise provided under the domestic tax laws of the country of residence, it is not mandatory for the country of residence to grant a credit for the tax paid in the State S.

4. Domestic Tax Systems

4.1 Introduction

Countries like The United States of America, India, The United Kingdom, France, Germany, Brazil, Singapore, France, China, etc. have a comprehensive taxation system. A common feature in various taxation systems is that tax is levied on the basis of source of income / residence of taxpayer / nationality, etc. Even combinations of the above are used for levying tax.

4.1.1. Constitutional Authority

Under entry 82 of the seventh schedule of Article 246 of the Indian Constitution, the Central government is empowered to levy tax on “**Taxes on income other than agricultural income.**” (Emphasis supplied).

4.1.2. Some basic concepts

In the context of International Taxation, it is to be noted that it is a subject which involves study of domestic tax legislation of various countries. International Taxation, through Double Tax Conventions also enables one to understand the taxing rights which a country exercises on its subjects.

Double Tax Convention is an agreement (usually bilateral) which is entered into by Countries which limits / restricts / modifies the taxing right of a particular Contracting State.

A treaty shall, normally, not create more burdens on the taxpayer. This statement is from an understanding that it is the domestic law of a country (which should be in accordance with the constitution of a country) which primarily gives a right to levy tax on its subjects. The DTAA neither grants / vests / nor allots the jurisdiction to tax.

Section 90(2) of the Income-tax Act, 1961 provides that if the provisions of the Act are more beneficial vis-à-vis the tax treaty, the provisions shall apply,

4.2 Doctrine of Taxation Policy

4.2.1 Introduction

For any robust system of taxation, it is essential to understand the basic principles of taxation⁵⁷ which are as follows:-

(i) Equity

Under this principle, it is advocated that tax is an obligation on every person having economic allegiance with the country from which benefits are derived. This is regardless of residential status of a person because even a non-resident earning income from the source country derives benefits which maybe direct or indirect from the country of source.

(ii) Convenience

In the epic Mahabharata, the author of the great saga “Ved Vyasa” has said that “*State Tax be such which should not prove to be a burden on the subject; the King should behave like those bees which collect honey without causing harm to the tree*”. The same had been reiterated by the author of the “Arthashastra” (meaning Economics) “The Great Acharya Chanakya”.

This philosophy suggests that taxes should be collected by the state (country) only when it is possible for the taxpayer to pay. Needless to say, the taxpayer shall also act in good faith and pay the due taxes to the King / Government.

(iii) Economy

The costs incurred for collection of taxes shall in no way be onerous to the state. This is for the primary reason that collection of taxes is for the benefit of the public and if the activity of tax collection turns out to be onerous, it is better that the state does not levy tax.

(iv) Certainty

The tax laws should be fair, simple to understand, and the payer must be aware of what and why he must pay such an amount in the form of tax.

Fundamentals of A Taxation Regime

4.3 Basic Structure of Taxation

India has a comprehensive and wide coverage of tax laws. For the purpose of understanding the basic structure, let us have a look at the Indian Income-tax Act, 1961 which is based on the

⁵⁷ Adam Smith in his book on “Wealth of nations” – Roy Rohatgi (Pg. 195)

fundamentals of the following –

- (i) Levy
- (ii) Computation
- (iii) Collection.

The law makers who may seek to levy any tax should bear in mind the above basic principles. This levy maybe in addition to the existing or in substitution of an existing levy or a new levy altogether. Also, the above three must complement each other and as a thumb rule, it must be followed in the chronological order as provided above. If it is not followed, it may lead to absurd consequences and add up to the complexities in the dynamic world of taxation.

4.3.1 Levy

- **Background – Powers that exist under domestic law**

As discussed above, the Central Government is empowered by the Indian Constitution to levy tax on income other than income from agriculture. A question may arise as to what does one mean by India?⁵⁸

To answer this question, let us refer to section 2(25A) of Act, below:

Section 2(25A) of Act, answers this question. It has defined India as

India “means the territory of India as referred to in article 1 of the Constitution, its territorial waters, seabed and subsoil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 (80 of 1976), and the air space above its territory and territorial waters”.

- **Constitutional Authority of Law enacted in India**

Article 245 of the Indian constitution, for this purpose is reproduced as under:-

“245. Extent of laws made by Parliament and by the Legislatures of State

- (1) *Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the States*
- (2) *No law made by Parliament shall be deemed to be invalid on the ground that it would have extra territorial operation”.*

- **Charging section**

It has been expressly provided that tax shall be levied only by authority of law. In other words, levy of tax cannot be implied, and the levy must be under the law. Therefore, it has been expressly provided under section 4 of Act which empowers the Central Government to levy tax

⁵⁸ Certain tax treaties have also defined ‘India’ for example, the USA, Russia, Phillippines, Singapore, etc.

on income of every person.

- **Person**

Person under Act, covers an individual (resident or non-resident), company, association of persons, body of individuals, partnership firms, LLPs, etc.

- **Importance of determining residential status of a person**

Some countries levy tax on the global income of its residents. India and USA⁵⁹ are the two of many other countries who follows this residence rule of taxation. Determination of residential status of a person has always been a very interesting subject on account of the following two reasons:-

- (i) Every country lays down separate provisions to determine the residential status of a particular person
- (ii) There are differences in the residence rules of different countries.

Due to the above two factors, there are likely chances that a person could end up being a resident of both the countries. In order to resolve this issue, a reference to Article 4 of various Indian DTAs may serve the purpose of deciding the residential status of a person. By virtue of the Multilateral Instrument (MLI) signed under the BEPS initiative of the OECD, the issue (if any) of dual residence would now be resolved by the Competent Authorities of both the Contracting states.

Determination of residential status is important because it can grant the country of residence the right to levy tax on the global income of its resident taxpayer. For example, section 5(1) [Scope of total income] of Act provides that the scope of total income of a resident includes (a) income received or deemed to be received in India, (b) income that accrues or arises or is deemed to accrue or arise in India during the year and (c) income that accrues or arises outside India during such year.

- **Section 6 [Residence in India]**

Section 6 of the Act provides different tests of conditions on fulfillment of which a person would be regarded as a resident in India for the purposes of taxation.

Type of person	Criteria for determining his residential status
Individual	Physical presence test is sufficient to determine residential status. This physical presence is regardless of the purpose of the visit in India. A deemed resident status has been introduced by the insertion of sub-section (1A) to section 6 effective 1-4-2021 under which an individual being a citizen of India having total income (other than income from foreign sources) exceeding Rs. 15 lakhs during the previous year shall

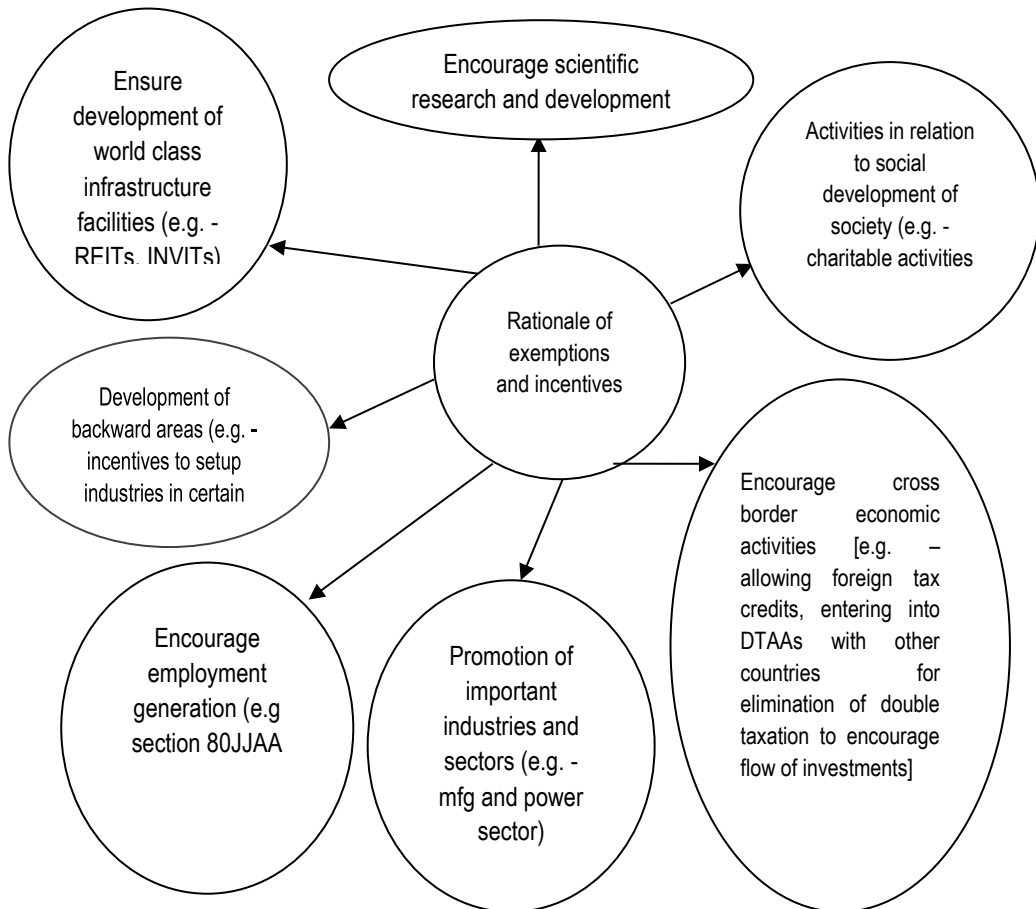
⁵⁹ USA, on the other hand levies tax on its citizens as well

Type of person	Criteria for determining his residential status
	be deemed to be resident in India if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature.
Hindu Undivided Family / Association of person / Partnership Firm / Any other person	Ordinarily, it is always considered to be resident in India unless, situs of the control and management of its affairs is situated wholly outside India . In other words, even if a part of control and management is situated in India, these persons very well run the risk of being considered as resident for the purpose of the Act. If at all there is a conflict in determining residential status, Article 4 of the tax treaty may come into play and the dispute may be settled accordingly. Further, if the dispute is not resolved by Article 4, it is the Mutual Agreement Procedure which must resolve the dispute on the residential status of the taxpayer. Further, the country of residence shall also provide relief by eliminating the effect of double taxation. The relief may be granted by the methods used for elimination of double taxation.
Company	Two conditions are provided. However, if any one of the two conditions is fulfilled, the company would be regarded as resident in India. Condition (i) If it is an Indian company. (ii) Place of Effective Management ⁶⁰ , in that year, is in India.

- **Coverage of taxable income**

Under general commercial understanding, a person could be earning income from multiple sources. These sources may be within the boundary of India and / or outside India. Keeping in mind the constitutional authority, the Parliament reserves a right to levy tax on entire income of each and every person. However, the Parliament in its own wisdom grants exemptions to various incomes from taxation. Some of the driving factors which explain the rationale behind policy of exemption and incentives are pictorially represented as follows -

⁶⁰ Explanation to section 6(3)(ii) of Income Tax Act provides that “*place of effective management*”(POEM) means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made. Central Board of Direct Taxation (CBDT) has vide circular 6 of 2017 dated 24 Jan 2017 issued final guidelines for determining POEM of a company



• Connecting Factors

The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business **with that country** or **in that country**. Internationally, the term used to determine the jurisdiction for taxation is **“connecting factors”**. **There are two types of connecting factors, namely, “Residence” and “Source”**. It means a company can be subject to tax either on its residence link or its source link with a country. Broadly, if a company is doing business with another country (i.e. host/source country), then it would be subject to tax in its home country alone, based on its residence link. However, if a company is doing business **in a host/source country**, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link. In such a situation, double taxation would arise.

In order to avoid such double taxation, a company can invoke provisions of DTAA (also known as Tax Treaty or Double Taxation Convention–DTC) with the host/source country, or in the absence of such an agreement, an Indian resident can invoke provisions of section 91 of the Act, providing unilateral relief in case of incidence of double taxation.

Consider the following situations.

Situation 1

Company ICO is a resident of India. It has set up a branch in UK. Here, India would be the country of residence for ICO, whereas UK would be the country of source.

UK would tax the profits earned by the branch of ICO located in UK, whereas ICO would be taxed on worldwide basis in India, including profits of its UK branch.

However, ICO can claim relief in respect of taxes paid in UK while filing its tax return in India under the Indo-UK Double Taxation Avoidance Agreement.

Situation 2

If, instead of UK, ICO has a branch in Pakistan, then it can claim unilateral relief under section 91 of the Act, in respect of taxes paid by its Pakistan branch as India does not have a tax treaty with Pakistan.

Let us examine in depth both situations which are as follows –

- (i) Doing business *with* India
- (ii) Doing business *in* India

Doing Business with India

- This implies that a foreign company is doing business with India from its home country or from any place outside India. In other words, it is a case of direct supply of goods and services to India. In this case goods are supplied, or services rendered directly from abroad without any business presence in India which in other words, is “offshore supply of goods and services”.
- In this case, the connecting factor or link is not strong enough to bring income earned (by such activity) into the tax net in India, e.g. income from export of goods and services to India. However, there are exceptions to this general rule. Section 9(1) of the Act seeks to tax income earned by a foreign company through any business connection in India, or income by way of Royalties and Fees for Technical Services when the payer is resident in India. Recently Finance Act 2018 has clarified that significant economic presence of a non-resident in India would constitute business connection in India which in-turn seeks to cover cases even where the non-resident does not have a fixed place of business in India. Pursuant to India’s commitment under the G20 for furtherance of the BEPS initiative and to counter artificial avoidance of permanent establishment status, India has now adopted a wider definition of business connection under its domestic legislation.

Doing Business in India

A foreign company may establish its presence in India in various forms. The taxability depends upon the mode/type of vehicle/entity used for doing business in India, as well as the nature of such income.

Generally, foreign companies carry on business in India in the following forms of entities:-

- **Liaison Office (LO)**

Provisions under Foreign Exchange Management Act

Present guidelines under FEMA permit a LO of a foreign entity in India to carry on following activities –

- Representing the parent company / group companies in India;
- Promoting export / import from / to India.
- Promoting technical/ financial collaborations between parent / group companies and companies in India.
- Acting as a communication channel between the parent company and Indian companies.
- Not allowed to undertake any business activity in India and cannot earn any income in India.
- Expenses of such offices are to be met entirely through inward remittances of foreign exchange from the Head Office outside India

Taxability of a LO

Usually, foreign companies enter India through the liaison office route. Under Foreign Exchange Management Act (FEMA) regulations, the LO is not permitted to do business and generate income in India. In such cases, its role is restricted to collection and dissemination of information on behalf of its principal. It is therefore, dependent on its head office for all its expenses with no tax liability arising consequently. Accordingly, the general perception is that LO does not create a taxable presence in India.

Exceptions to the general rule provided for Liaison Office

- If the activities carried on by the LO can be classified as that of a PE, in such cases, taxability of the income attributable to the LO in India may arise.
- Various Courts⁶¹ have held that since LO is carrying on certain commercial activities which were the core activities of the taxpayer, LO constitutes PE and the income attributable to such LO is taxable in India.
- With the advent of technology in the manner business operations is carried out and advancement of the digital economy, the issue of determination as to whether a LO constitutes a PE or not shall have to be re-examined as activities which were considered as preparatory and/or auxiliary under the conventional business models may get transformed to core business functions. In view of the above, there are certain activities which if undertaken by the LO may run the risk of a PE being triggered either in the form of an agency PE or by way of falling outside the preparatory or auxiliary clause.
- The Base Erosion and Profit Shifting report on Action Plan 7 states that Dependent Agent

⁶¹ GE Energy Parts Inc. v. ADIT(Intl) [2017] 78 taxmann.com 2 (Del); Brown & Sharpe Inc. v. ACIT [2014] 41 taxmann.com 345 (Del); Jebon Corporation vs. CIT(Intl.) [2012] 19 taxmann.com 119 (Kar)

PE shall exist where a person on behalf of an enterprise habitually concludes a contract or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. The LO carrying on activities such as vendor selection, negotiating price and similar other activities which in some way or the other lead to substantial negotiation of contracts i.e. not just conclusion of contracts may also trigger creation of agency PEs of overseas enterprises in the host jurisdictions.

- **Joint Venture/ Subsidiary**

Business Profit

A foreign company may enter into a joint venture or set up a wholly or partly owned subsidiary for doing business in India. In both cases, the company incorporated in India, will become an Indian company and subject to tax at the rate applicable to a domestic company, which is presently at 30% plus applicable surcharge and cess.

Dividend Income

Prior to 1 April 2020, dividends distributed by an Indian company were exempt in the hands of the recipient. Further, as per section 115BBDA of the Act, dividend in excess of 10 lac per annum received by resident individuals, HUFs and firms were taxable at the rate of 10% of the gross amount of such dividend. Therefore, a foreign company, receiving dividends from its subsidiary in India was not to be taxed, though the subsidiary was subject to dividend distribution tax.

With effect from 1 April 2020, following amendments have been made in the Act:

Dividend distribution tax under section 115-O is payable only in respect of the dividends declared, distributed or paid by domestic companies on or before 31 March 2020. With effect from 1st April 2020, dividend income shall be taxable in the hands of recipients i.e. shareholders;

The exemption available under section 10(34), to recipients of dividend income has been withdrawn.

Section 80M has been reintroduced to provide that where the gross total income of a domestic company includes dividend from another domestic company or a foreign company or a business trust, deduction under this section would be available to the recipient company to the extent of dividends distributed by the recipient company on or before one month prior to the due date of filing of return of that year

- **Branch Office**

This is a crucial form of business entity, which attracts full rate of tax as applicable to a foreign company. The Branch of a foreign company is subject to tax @ 40% along with applicable surcharge and cess. The Branch is an extension of its head office and is considered as Permanent Establishment (PE) of the foreign company under DTAA. Profits accruing to a foreign company, attributable to its branch in India, are taxable in India.

- **Agent**

Many companies do business in India by appointing an agent. Under the provisions of DTAA, if the agent is an independent entity and is acting in the ordinary course of business, then this arrangement would not result in any tax liability for the foreign company as, such a situation would tantamount to doing business with India. However, if the agent is a dependent entity, then it would become a Permanent Establishment of the foreign company in India and profits attributable to activities of such an agent in India in that capacity will be taxable. The Finance Act, 2003 incorporated the concept of 'Agency PE' as prevalent in tax treaties, in the Act. Explanations 2 and 3 have been added to Section 9(1)(i) of the Act to this effect. Pursuant to recommendations of the BEPS under Action Plan 7, India has now vide Finance Act 2018, modified the existing provisions of s. 9 to align the scope of "business connection" with modified PE Rule as per the MLI signed under the BEPS initiative. The said Action plan recommended introduction of anti-fragmentation rules to prevent the taxpayer from circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of functions which were otherwise whole activities, for the purposes of availing benefit of exemption under para 4 of Article 5 of the DTAA.

4.3.2 Unique Features of Domestic Tax Laws In India

- **Unilateral foreign tax credit**

India has a large tax treaty networks. Presently, India has signed 97⁶² comprehensive tax treaties and approximately 8 limited tax treaties. Ideally, tax credit is given by the Country of residence which follows comprehensive tax system (i.e. where residents are taxed on their global income) in respect of taxes paid in the source State. Such credit is usually restricted to the proportionate amount of tax payable in respect of such income in the State of residence.

In order to promote foreign trade and make India a net export surplus country, a series of steps have been adopted by the Government of India by providing various incentives, deductions, exemptions, etc. under various laws.

For example, under the Foreign Exchange Management Act, 1999, (i) ceiling limit under Liberalized Remittance Scheme has been revised and at present it stands increased to USD 250,000 per Financial Year (ii) For the purpose of overseas direct investments by eligible Indian parties, currently, the ceiling limit is 400% of the net worth as per the last audited balance sheet.

The CBDT has issued Notification⁶³, in exercise of the powers conferred by clause (ha) to sub-section (2) of section 295 of the Act⁶⁴ prescribing the Rules⁶⁵ for claiming Foreign Tax Credit effective from 01 April 2017.

Section 91 of Act, India (country of residence) enables its residents to avail of unilateral tax

⁶²⁶²<https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx> - as on 16September 2019

⁶³Notification No. 54/2016/F.No. 142/24/2015-TPL dated 27 June 2016

⁶⁴Introduced by Finance Act, 2015

⁶⁵Rule 128 of Income-Tax Rules, 1962

credit for foreign taxes paid outside India in a country with which India has not signed any tax treaty. The following are some of the essential conditions on fulfillment of which unilateral tax credit is available:-

- (i) Person claiming credit must be resident in India for the said previous year;
- (ii) Income is from a source outside India. In other words, income shall not be deemed to accrue or arise in India;
- (iii) Tax has been paid in the foreign country;
- (iv) There is no agreement under section 90 for the relief or avoidance of double taxation.

A question may arise that what if there is an agreement with the foreign country (source country) but the tax which is paid is not covered by the tax convention?

The Mumbai Tribunal *in the case of Tata Sons Ltd [2011] 10 taxmann.com 87 (Mum.)* throws some light on section 91 and availability of credit in India of taxes paid in foreign country. It was held by the Tribunal that:-

*“It was indeed an incongruous position that payment of State Income-taxes in US and Canada were not allowed deduction as those were treated as in the nature of taxes on income, in terms of the provisions of domestic tax law in India, and those payments were also not being taken into account for granting credit for taxes paid abroad by the assessee, as only **Federal Income-tax** was eligible for tax credit in terms of the Indo-US and Indo-Canada tax treaty. If that approach was adopted, the assessee would not get a deduction of State taxes so paid abroad, nor would he get the tax credit for the same, and if those two propositions were correct, there was clearly an inherent contradiction in those propositions on tax treatment for State Income-taxes paid abroad. There cannot obviously be a tax payment which is neither treated as admissible expenditure, because it is treated as an Income-tax, nor is it taken into account for tax credits, because it is not to be treated as Income-tax. It was incorrect to proceed on the assumption that State Income-tax paid in USA, or in Canada, cannot be taken into account for the purposes of computing admissible tax credits. **It was so for the elementary reason that the provisions of a tax treaty, based on which tax credits are said to be inadmissible, cannot be pressed into service to decline a benefit to the assessee which is otherwise available to him, even in the absence of such a tax treaty, under the provisions of the Income-tax Act.***

Even as it was held that, in principle, State Income-taxes paid in USA are eligible for being taken into account for the purpose of computing admissible tax credit under section 91, but the fact that section 91 refers to a situation in which the assessee has paid tax ‘in any country with which there is no agreement under section 90 for the relief or avoidance of double taxation’ and that was indeed an agreement under section 90 with United States of America, as also with Canada, could not be ignored. If one adopts a literal interpretation of such provisions, and bearing in mind the undisputed position that tax credit provisions under section 91 are more beneficial to the assessee vis-a-vis the tax credit provisions in related tax treaties inasmuch as while section

91 permits credit for all Income-tax paid abroad - whether State or Federal, relevant tax treaties permit credits in respect of only Federal taxes, it will result in a situation that an assessee will be worse off as a result of the provisions of tax treaties. That certainly is not permissible under the scheme of the Income-tax Act. Circular No. 621, dated 19-12-1991 issued by the Central Board of Direct Taxes, which is binding on the Assessing Officer under section 119(2), inter alia, observes that "Since the tax treaties are intended to grant relief and not put residents of a Contracting State at a disadvantage vis-a-vis other taxpayers, section 90 of the Income-tax Act had been amended to clarify any beneficial provisions in the law will not be denied to a resident of a contracting country merely because corresponding provisions in a tax treaty is less beneficial."**(Emphasis supplied)**

Karnataka High Court in the case of Wipro Ltd. (382 ITR 179)⁶⁶ while dealing with the credit of State taxes, held that:-

"The question whether the assessee is entitled to the aforesaid benefit when India has no agreement with the States where tax is levied on the income of the assessee is specifically dealt with in section 91.

*The said provision provides for deduction of the tax paid in any country from the Indian income tax payable by him of a sum calculated on such doubly taxed income even though there is no agreement under section 90 for the relief or avoidance of double taxation. Explanation (iv) defines the expression income tax in relation to any country includes any excess profit tax or business profits tax charged on the profits by the Government of any part of that country or a local authority in that country. Therefore, the intention of the Parliament is very clear. The income tax in relation to any country includes income tax paid in any part of the country or a local authority. It applies to cases where in a Federal structure a citizen is made to pay Federal income tax and also the State income tax. **The income tax in relation to any country includes income tax paid not only to the Federal Government of that country, but also any income tax charged by any part of that country meaning a State or a local authority, and the assessee would be entitled to the relief of double taxation benefit with respect to the latter payment also.** Therefore, even in the absence of an agreement under section 90, by virtue of the statutory provision, the benefit conferred under section 91 is extended to the income tax paid in foreign jurisdictions. India has entered into agreement with the Federal Country and not with any State within that country. In order to extend the benefit of this, relief or avoidance of double taxation, aforesaid explanation explicitly makes it clear that income tax in relation to any country includes the income tax paid to the Government of any part of that country or a local authority in that country. **Therefore, even though, India has not entered into any agreement with the State of a Country and if the assessee has paid income tax to that State, the income tax paid in relation to that State is also eligible for being given credit to the assessee in India.**" (Emphasis supplied)*

In this regard, attention may also be invited to the decision of the Delhi Tribunal in case of

⁶⁶ The case of Wipro Ltd. is currently pending for adjudication before the Supreme Court

Manpreet Singh Gambhir [2008] 26 SOT 208 (Delhi) where it has been held as under:

“Referring to Article 2, the taxes covered under the DTAA are in respect of taxes paid in the United States only for the Federal Income-tax imposed by internal revenue code and not the State Income-tax.”

Also, Rule 128 of the Income Tax Rules provides that foreign tax credit in respect of countries with which India has entered into agreement, shall be ‘tax covered under the said agreement’.

In this context, the relevant extract of Article 2 of the India US DTAA is as under:

“The existing taxes to which this Convention shall apply are: (a) in the United States, the Federal income taxes imposed by the Internal Revenue Code.....”(Emphasis supplied)

While, the Karnataka High Court in the case of Wipro ruled in favour of the taxpayers and allowed the claim for credit of State taxes as well, the revenue authorities here may argue that the decision of Karnataka High Court in the case of Wipro was rendered when there were no FTC Rules.

In view of the express language of Article 2 of the India-USA DTAA, unambiguous language of the FTC Rules and contrary view from the Delhi Tribunal decision in the case of Manpreet Singh Gambhir (supra) the issue may continue to be litigative until the Apex Court pronounces its verdict on the issue or the Legislators amend the provisions to clarify the position.

- **Treaty provisions overriding domestic tax laws**

Income Tax Law in India is subject to Double Tax Avoidance Agreement provisions. Therefore, wherever the treaty exists, the taxability in a cross-border transaction of goods and services should be decided by taking into account both the domestic law and the DTAA. Section 90(2) specifically provides that the assessee shall have the option to apply the beneficial provision under domestic law or DTAA.

Now, let us highlight some of the provisions which are more beneficial under the treaty vis-à-vis the domestic tax law.

For the purpose of understanding, let us take a look at the provisions of section 9(1)(vi) [Royalty] of Act.

Part A

Section 9(1)(vi) of the Act - “Royalty Income”

a. Explanation 4 to section 9(1)(vi) of the Act

Inserted with retrospective effect from 01 June 1976, consideration paid for transfer of right for use or right to use a computer software is regarded as royalty income. Explanation 4 has been inserted which clarifies that the transfer of all or any right:-

- In respect of any right, property, information (ex- computer program)
- Includes and has always included

- Transfer of all or any right for use or right to use a computer software
- Irrespective of medium through which such right has been transferred.

Therefore, the scope is enlarged under the domestic tax law in so far as the definition of royalty income is concerned. However, in the absence of similar amendments in the DTAA provisions, the Mumbai Tribunal in the case of *B4U International Holdings Ltd [2012] 18 ITR (T) 62* has held that the taxability of the copyrighted article as Royalty income will not fall within the ambit of Royalty under DTAA as the DTAA does not consider such payment as royalty amount but seeks to tax such payment as business profit. Therefore, without having a tax exposure of a Permanent Establishment in India, such payment cannot be taxed in India.

b. Explanation 5 to section 9(1)(vi)

It has been the Revenue's contention that bandwidth charges paid to telecom companies can be sought to be taxed as royalty since it is payment for use of a process or payment for use of equipment.

Process means a series of steps taken to achieve desired results which is different from the original element i.e. it implies a change. The bandwidth facility provided by a telecom company is towards data transmission and therefore since the data sent and received are the same facilities, the same cannot be considered as a process and hence before the amendment made in the Finance Act (FA), 2012, it was not considered as "royalty". Similarly, a use or right to use equipment as held by various courts involves the users to do some positive act in relation to the equipment such as operation and control of the same in order to utilize the facility. Since the equipment is in possession and control of telecom service provider, therefore, the user cannot be said to be using the equipment but would be considered as availing the benefit of equipment. Hence the payment cannot be said to be a royalty payment prior to amendment by FA 2012.

However, after the amendment by the FA 2012 explanation 5 to section 9(1)(vi) with retrospective effect has targeted such payment within the scope of royalty income irrespective of the location of the property and the control and possession over such property. The overall taxability would still depend upon the DTAA even after FA 2012.

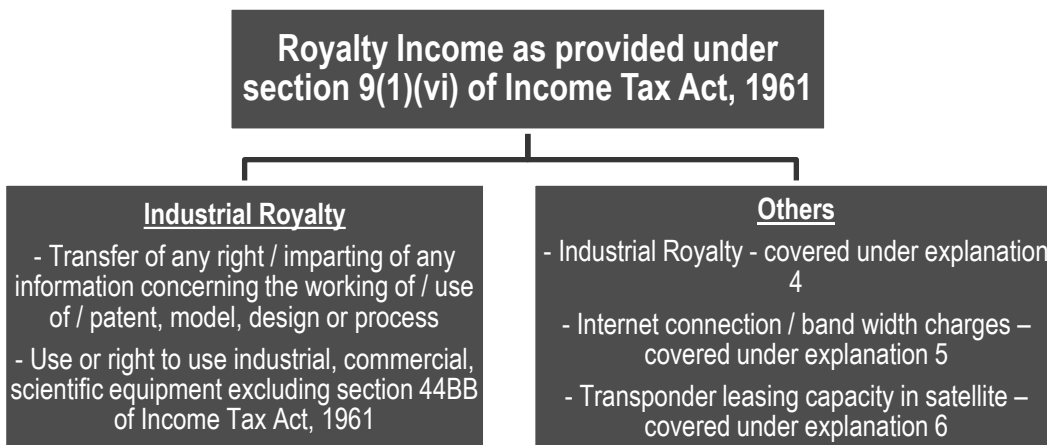
c. Explanation 6 to section 9(1)(vi)

Whether leasing of the transponder capacity in a satellite considered as royalty income has been litigated.

It was held in *Asia Satellite*⁶⁷ case that the satellite or the transponder equipment was in the possession and control of the operator and was never handed over to the customer who merely is given the access to the broadband capacity available. The customer also does not use the process, but it is the satellite operator who uses the process to provide service to the customer. Further, the taxpayer argued that the satellite transmission process was not a secret process to fall under Explanation 2 to section 9(1)(vi). The High Court held that such payments for satellite

⁶⁷ *Asia Satellite Telecommunications Co Ltd v DIT [2011] 9 taxmann.com 168 (Delhi).*

transponder capacity is not royalty under the Act. However, explanation 6 inserted by FA 2012 specifically includes “transmission by satellite, cable or any other technology”. The intent of the law is to include transponder payments as royalty income under the domestic tax law. However, its overall taxability in a cross-border transaction would be decided as per DTAA.



4.3.3 Importance of Domestic Tax Laws

- **Considering India as a source country**

Under the existing regime, Section 10(38) of the Act, as amended by Finance Act, 2017, provides exemption on long term capital gains (LTCG) arising on account of transfer of equity shares of a company listed on recognized stock exchange in India, acquired on or after 01 October 2004 and where securities transaction tax has been paid, other than the acquisition notified by the Central Government in this behalf. Finance Act, 2018 has withdrawn the aforesaid exemption in respect of income from such LTCG arising on or after 1 April 2018. Accordingly, a such LTCG exceeding INR 1,00,000 shall be taxed at the rate of 10%. In such a case, the gains arising on transfer of such shares would be taxable in both, India as well as country of residence.

There are various instances where the provisions of DTAAs are more beneficial than the provisions of the domestic tax laws. However, as a cardinal rule of applying DTAA provisions, it needs to be noted that DTAAs are primarily entered by Governments to “eliminate the problem of double taxation” which is otherwise not available under the domestic tax laws. The Supreme Court approved, in *Azadi Bachao Andolan*,⁶⁸ the judicial consensus in India that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a double taxation avoidance agreement. When notified, the provisions of such an agreement, with respect to cases to which where they apply, would operate even if inconsistent with the provisions of the Income-tax Act.

Section 90(2) of the Act clarifies India’s stand in relation to a conflict between DTAA v/s. Domestic Tax Law. It is provided that in relation to an assessee to whom such agreement

⁶⁸ Union of India v Azadi Bachao Andolan [2003] 132 Taxman 373 (SC).

applies, the provisions of the Act to the extent they are more beneficial to that assessee shall apply. This ensures that a person would not be saddled with additional tax liability on application of DTAA which is otherwise not possible through the application of domestic tax laws.

4.3.4 Option of Choice – Head wise or Source wise??

In order to understand the concept, let us consider the following illustration –

Facts

- (a) A. Ltd, an Indian Company is engaged in the business of manufacturing and selling of cut and polished diamonds.
- (b) A. Ltd carries on its business outside India through branches.
- (c) In one of its branches, say the UK branch, it has incurred loss and it has earned profits from its Gabon branches.

Provisions of Income-tax Act, 1961

Under the provisions of Income-tax Act, 1961, global income of A Ltd. is taxable in India. In order to compute the taxable income in India, income from all the sources (including income from foreign branches) will be clubbed.

Issue

- (a) India has a DTAA with UK. However, there is no such DTAA with Gabon.
- (b) A Ltd. has paid taxes in Gabon. It has incurred a loss in the UK and therefore, the tax liability in UK is NIL.
- (c) In such cases, how would A Ltd. compute the foreign tax credit available in India?

Solution

Bombay High Court In the case of Bombay Burmah Trading (259 ITR 423), in the context of section 91 of the Income-tax Act, 1961, held that –

“If one analyses S. 91(1) with the Explanation, it is clear that the scheme of the said section deals with granting of relief calculated on the income country wise and not on the basis of aggregation or amalgamation of income from all foreign countries. Basically u/s. 91(1), the expression ‘such doubly taxed income’ indicates that the phrase has reference to the tax which the foreign income bears when it is again subjected to tax by its inclusion in the computation of income under the Income-tax Act. Further S. 91(1) shows that in the case of double income-tax relief to the resident, the relief is allowed at the Indian rate of tax or at the rate of tax of the other country whichever is less. Therefore, the relief u/s.91 (1) is by way of reduction of tax by deducting the tax paid abroad on such doubly taxed income from tax payable in India. Under the circumstances, the scheme is clear. The relief can be worked out only if it is implemented country wise. If incomes from foreign countries were to be aggregated, it would be impossible to compare the rate of tax of the foreign country with the rate under the Indian Income-tax Act”. (Emphasis Supplied).

Therefore, relying on the above decision, the entire income-tax paid on the Gabon sourced income would be available as credit against the Indian income-tax chargeable on such Gabon sourced income. Such credit will be fully available without setting off of the loss suffered in the UK. This conclusion is also borne by rule 128(5) (foreign tax credit rule) which provides that the credit of foreign tax shall be the aggregate of the amounts of credit computed separately for each source of income arising from a particular country or specified territory outside India.

4.3.5 General Anti-Avoidance Rules [GAAR]

“Chapter X-A [General Anti-Avoidance Rules]” are applicable from A.Y. 2018-19 (provided by FA 2015) which overrides the provisions of DTAA and the provisions of domestic tax law prevails. These provisions can be invoked only when the arrangement entered into by the assessee subject to said chapter X-A has been regarded as an **“impermissible avoidance arrangement”**. The purpose of introducing GAAR to Income Tax law is to discourage abusive strategies adopted to reduce tax liability by employing artificial means.

4.3.6 Domestic tax law v/s. Tax Treaty

Tax Treaty	Domestic Tax Law
1. Agreement between two contracting states	1. Enacted by Parliament (it is a law of a country/state)
2. Undergoes series of negotiations	2. Formulated according to wisdom of the country
3. Primary objective – eliminate double taxation	3. Provides mechanisms for levy, computation and collection of taxes
4. No additional tax burden	4. Major source of revenue for the Government. Right to tax authorized by the Parliament.
5. There are no amendments	5. The law gets amended as per the wisdom of the Parliament
6. It is public international law	6. It is a national legislation
7. Resolution of disputes through mutual agreement procedure	7. Disputes are settled by appellate authorities/Courts
8. No charging section	8. Charging section is mandatory in the legislation
9. Taxing rights get allocated, restricted, etc.	9. Law must be in accordance with the Constitution

4.4 Understanding Section 5, Section 6 and Section 9 of Income Tax Act, 1961

International taxation, as discussed earlier is nothing but study of international tax aspects (cross border tax aspects) under domestic tax laws and study of cross border tax treaties, etc.

The connecting factors (residence and source) as discussed earlier under the provisions of the Act will eventually lead a person to the universe of international taxation.

4.4.1 Residential Status

Let us understand the provisions of residence in detail first as provided under Income Tax law. Save as otherwise provided, all the provisions of Act, apply to a person who is resident in India.

- **Important Provisions of section 6⁶⁹ are as under**

- **For individuals [Section 6(1)]**

- a. Present in India for 182 days or more; or
- b. ** (this clause is omitted)
- c. Within four years preceding that year, been in India for 365 days or more and in the previous year, been in India for 60 days⁷⁰ or more.

Explanation 1 to section 6(1)

Explanation 1(b) to section 6 provides that in respect of an Indian citizen and a person of Indian origin who visits India during the year, the period of 60 days as mentioned in (b) above shall be substituted with 182 days. Explanation 1(a) to section 6 also provides similar concession to the Indian citizen who leaves India in any previous year as a crew member or for the purpose of employment outside India.

The Finance Bill, 2020 (as presented on 1st February 2020) proposed an amendment to the Explanation 1(b) that the concession in the period of stay in India, for an Indian citizen and a person of Indian origin, shall be reduced from 182 days to 120 days. Further, at the time of enactment, Finance Act has restricted the application of amended provisions of Explanation 1(b) only to that Indian citizen or a person of Indian origin whose total income, other than income from foreign sources, exceeds Rs. 15 lakhs during the previous year. For this provision, income from foreign sources means income which accrues or arises outside India (except income derived from a business controlled in or a profession set up in India).

Explanation 2 to section 6(1)

CBDT, vide its notification dated 17th August, 2015 has issued a Notification “S.O. 2240(E)” as per the powers conferred under section 295 of Act. It has been specifically provided that the period of 182 days or more in the case of individual being Indian citizen and a member of crew ship, the period or periods of stay shall not include period beginning from the date entered into

⁶⁹ Section 6(6) is discussed with section 5(1) for more clear understanding

⁷⁰ In case of Indian citizen or person of Indian origin who leaves India for the purpose of employment outside India or coming on a visit to India the words sixty (60) shall be substituted with one hundred eighty two (182) days

the Continuous discharge certificate⁷¹ in respect of joining the ship by such individual till the date entered into the continuous discharge certificate in respect of signing off by that individual from the ship in respect of such eligible voyage⁷².

Deemed Residency Rule introduced by Finance Act 2020

Finance Act 2020 has introduced a new section 6(1A) in the Act. As per the said section, an individual, being a citizen of India, having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the previous year, shall be deemed to be resident in India in that previous year, if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature.

Interim relief due to COVID-19 for PY 2019-20 in respect of residency under section 6 of the Act

The CBDT vide circular 11/2020 issued dated 8th May, 2020 relaxed the provision of Section 6 of the Act for residency of a person who had come on a visit to India during the previous year 2019-20 for a particular duration and intended to leave India before the end of the previous year for maintaining their status as non-resident or not ordinary resident in India. However, due to declaration of the lockdown and suspension of international flights owing to outbreak of Novel Corona Virus (COVID-19), they are required to prolong their stay in India.

For the purpose of determining the residential status under section 6 of the Act during that PY in respect of an individual who has come to India on a visit before 22nd March, 2020 and:

(a) has been unable to leave India on or before 31st March, 2020, his period of stay in India from 22nd March, 2020 to 31st March, 2020 shall not be taken into account; or

(b) has been quarantined in India on account of Novel Corona Virus (Covid-19) on or after 1st March, 2020 and has departed on an evacuation flight on or before 31st March, 2020 or has been unable to leave India on or before 31st March, 2020, his period of stay from the beginning of his quarantine to his date of departure or 31st March, 2020, as the case may be, shall not be taken into account; or

(c) has departed on an evacuation flight on or before 31st March, 2020, his period of stay in India from 22nd March, 2020 to his date of departure shall not be taken into account.

➤ For Hindu undivided family, firm or other association of persons [Section 6(2)]

Considered to be resident in India except where the control and management of its affairs is situated wholly outside India.

⁷¹ Meaning as assigned to it under Merchant Shipping Rules, 2001 made under the Merchant shipping Act

⁷² As per Rule 126 of the Income Tax Rules, voyage undertaken by a ship engaged in carrying of passengers or freight in international traffic where voyage originated from any port in India has its destination as any port outside India and vice versa.

➤ **For Companies⁷³ [Section 6(3)]**

The corporate residency has been redefined. It is provided under section 6(3) that -

“A company is said to be resident in India in any previous year, if-

- (i) *It is an Indian company; or*
- (ii) *Its place of effective management, in that year, is in India”⁷⁴.*

Place of effective management has been defined as the place where Key Management and commercial decisions Necessary for conduct of business of an entity as a whole are in substance made.

➤ **For every other person other than individuals and companies [Section 6(4)]**

Every other non-individual person is considered to be a resident unless the control and management of affairs is wholly situated outside India.

➤ **Section 6(5)**

If a person is considered as resident in India for one source of income, he is deemed to be resident for all sources of income.

● **Judicial Precedents on Residential Status**

➤ In relation to section 6(1)

In the case of CIT V/s. O. Abdul Razak, (2011) (198 Taxman 1) (Ker), it was held that - From the memorandum explaining the provisions of the Finance Bill introducing the Explanation (a) to section 6(1)(c) and the CBDT’s Circular No. 346 dated 30-6-1982, it is clear that no technical meaning is intended for the word ‘employment’ used in the Explanation. Going abroad for the purpose of employment only means that the visit and stay abroad should not be for other purposes such as a tourist, or for medical treatment or for studies or the like. Going abroad for the purpose of employment, therefore, means going abroad to take up employment or any avocation referred to in the circular, which takes in self-employment like business or profession. So much so, taking up own business by the assessee abroad satisfies the condition of going abroad for the purpose of employment covered by the Explanation (a) to section 6(1)(c).

➤ In relation to section 6(2)

- a. In the case of CIT V/s V. VR. N.M. Subbayya Chettiar, (1947) 15 ITR 502, 512 (Mad) subsequently affirmed by SC in case of the same assessee (1951) (19 ITR 168) and Erin Estate, Galah V/s CIT, (1958) 34 ITR 1 (SC), it has been held that *“control and*

⁷³ Defined under section 2(17) of Income Tax Act, 1961

⁷⁴ The amended provisions of section 6(3) are effective from 1 April 2017 and accordingly apply to AY 2017-18 and subsequent AY’s

management” signifies, in the present context, the controlling and directive power, “the head and brain”, as it is sometimes called, and “situated” implies the functioning of such power at a particular place with some degree of permanence, while “wholly” would seem to recognize the possibility of the seat of such power being divided between two distinct and separate places”.

- b. In the case of *B. R. Naik V/s CIT*, (1945) 13 ITR 124 (Bom); (1946) 14 ITR 334 (Bom); *CIT V/s Nandlal Gandlal*, (1960) 40 ITR 1, 7 (SC); *CIT V/s PL. M. TT. Firm*, (1973) 87 ITR 260 (Mad), it was held that “the expression “control and management” under this section signifies controlling and directive power, “the head and brain” as it is sometimes called. Furthermore, it is settled, that the expression “control and management” means *de facto* control and management and not merely the right or power to control and manage”.
 - c. In the case of *CIT V/s Chitra Palayakat & Co*, (1985) 156 ITR 730 (Mad), it was held that “mere presence of the managing partner in India cannot by itself lead to the inference that control and management of the affairs of the firm have been exercised in India”.
 - d. In the case of *Radha Rani Holdings (P) Ltd.*⁷⁵, it was held that since the Board of Directors, subject to the overall supervision of shareholders, actually control and manage the affairs of a company effectively as against the day-to-day operation of the company, the situs of the Board of Directors of the company should determine the place of control and management of the company. This does not mean where one or more of the Directors normally reside but where the Board actually meets for the purpose of determination of the key issues relating to the company.”
 - e. In the case of *Saraswati Holding Corpn Inc.*⁷⁶, the Delhi Tribunal held that “the law is well-settled that control and management of affairs does not mean the control and management of the day-to-day affairs of the business. The fact that discretion to conduct operations of business is given to some person in India would not be sufficient. The word ‘control and management of affairs’ refers to head and brain, which directs the affairs of policy, finance, disposal of profits and such other vital things consisting of the general and corporate affairs of the company.”
- **Redefining corporate tax residency [section 6(3)]**
 - There are two conditions prescribed under section 6(3) of the Act in order to consider a company to be resident in India.
 - The first condition provides that if a company is incorporated in India, it is considered, for the purposes of the Act, to be resident in India.
 - The amended second condition, i.e. the expression “place of effective management” has

⁷⁵ (2007) (16 SOT 495) (DELHI)

⁷⁶ (2007) (16 SOT 535) (DELHI)

substituted the phrase “control and management.....” in clause (ii) of section 6(3).

➤ Amendment in the second condition of Income Tax Law

Exchange control regulations in India were liberalised after economic reforms in the year 1991. The purpose was to promote global trade and commerce. However, various business groups, to avail tax advantages, had set up corporations in tax havens and / or low tax jurisdictions. Globally, multinationals including Google, Amazon and many others have been accused of avoiding taxes worth billions of dollars / pounds by strategically locating themselves in tax haven jurisdictions and / or low tax jurisdictions and also adopting business models which are very tax aggressive in nature. A corporation being an artificial person does not have a brain, hands, legs, etc. of its own. It is the management personnel who control the affairs of the company. These personnel may be situated anywhere in the world. In many countries, global income of its residents is taxable. Therefore, by considering an offshore company as a resident based on its place of effective management acts as a deterrent by considering the said offshore corporation as a resident for tax purposes and provisions of the law are applied accordingly.

This POEM concept has been taken from the OECD commentary⁷⁷ and to align the rules of residence for companies with the rules contained in the treaties. The discussion in the OECD Model Commentary on the meaning of the said expression should be useful to understand and interpret the concept for the purpose of Income Tax Act, 1961.

Professor Klaus Vogel on Double Tax Conventions (3rd Edition Para 105 page 262)

It has been provided that for the purpose of determination of POEM, what is decisive is not the place where the management directives take effect but rather the place where they are given. Thus, it is “**planning**” and not “**execution**” which is decisive.

➤ The explanatory memorandum to the Finance Bill, 2015 provides that-

*“Due to the requirement that whole of control and management should be situated in India and that too for whole of the year, the condition has been rendered to be practically inapplicable. A company can easily avoid becoming a resident by simply holding a board meeting outside India. This facilitates creation of shell companies which are incorporated outside but controlled from India. ‘Place of effective management’ (POEM) is an internationally recognized concept⁷⁸ for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognise the concept of ‘place of effective management’ for determination of residence of a company as a tie-breaker rule for avoidance of double taxation. Many countries prefer the POEM test to be appropriate test for determination of residence of a company. The principle of POEM is recognized and accepted by Organisation of Economic Cooperation and Development (OECD) also. **The OECD commentary⁷⁹ on model convention***

⁷⁷Last reference to the concept has been in the 2014 update of the commentary.

⁷⁸ The concept of Place of effective management in reality is an attempt to adopt the substance over form approach to counter tax avoidance strategies whose sole intention is to gain tax advantage.

⁷⁹ 2014 update

provides definition of place of effective management to mean the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole, are, in substance, made". (Emphasis supplied)

➤ **CBDT Guiding Principles**

In January 2017, the CBDT issued guiding principles vide Circular No. 06/2017 dated 24 January 2017. The said guiding principles may be considered as an effective tool to determine the POEM of a particular company. The guiding principles are primarily based on the fact as to whether or not the company is engaged in 'active business outside India'. For determination of 'active business outside India' factors such as passive income, total asset base, the number of employees, payroll expenses in India and outside, etc. are considered. The guiding principles state that the concept of POEM is one of substance over form. However, the real determination of POEM of a company is essentially an exercise which may be driven by complex set of facts. It is only after appreciating the factual position that the POEM of a company may be determined for the purpose of tax residency in India. The CBDT released clarification on 23 February 2017 stating that the provision of clause (ii) of sub-section 3 of section 6 of the Act, shall not apply to a company having turnover or gross receipts of INR 50 crores or less in a financial year.

➤ **Analysis of the definition**

Place of effective management (POEM) has been defined as -

- A place where;
- Key management and commercial **decisions**
- That are **necessary** for the conduct of the business;
- Of an **entity as a whole**
- Are in **substance made (emphasis supplied)**

The explanatory memorandum provides that the meaning of POEM as provided in OECD must be considered. Some directive principles are provided (which are discussed in later part of POEM). Therefore, one may take a view that in such cases, it is the dictionary meaning which must be adopted for the purposes of correct interpretation. For such purposes, let us consider the dictionary meaning of the following expressions -

- (i) *Key*⁸⁰: - A determining factor in accomplishing or achieving something.
- (ii) *Management*⁸¹: - The person or persons who control or direct a business or other enterprise.
- (iii) *Commercial*⁸²: - of or relating to commerce; engaged in commerce.

⁸⁰<http://www.thefreedictionary.com/key>

⁸¹<http://www.thefreedictionary.com/management>

⁸²<http://www.thefreedictionary.com/commercial>

(iv) *In substance*⁸³: - in reality; essentiality.

➤ *Made*⁸⁴: - invented; prepared; bring about; to put into existence.

➤ **International understanding of POEM and as understood by India**

OECD Guidelines

It is accepted internationally that ascertainment of POEM is a fact driven exercise and no single rule can be applied for determining the POEM of a company. In other words, without understanding the facts in detail, one cannot ascertain the POEM for a company. The OECD has provided some directive principles. These principles are not binding on taxpayers and neither on the tax authorities. However, they play an important role and can assist in determining the POEM of the Company. The principles provide the following -

- a. One must consider and recognise the place where decisions are made,
- b. Where the actions are determined,
- c. Where is the decision-making function performed,
- d. Where is the place of incorporation, where are corporate documents kept / stored / maintained,
- e. Place where CEO, office staff, senior executives reside to carry out activities.

➤ **UN Model Convention (2011) and Directive principles**

These guidelines suggest consideration of the following factors to determine the POEM

- a. Place where company is managed and controlled
- b. Place from where decisions are taken by the top management which are essential for the company
- c. Contribution of a place in the management of the company from an economic and functional point of view

➤ *Indian DTAA*

The Protocols and Memorandum attached / annexed to a tax treaty play an important role in tax treaty interpretation. These protocols and memorandums are a part of tax treaty, and it has a significant impact in application of DTAA (including protocol and memorandum). Various Court rulings have also considered the protocols and memorandums before pronouncing any decision in relation to international taxation matters. Article 4 of the India-Belarus tax treaty provides the following understanding -

*“With reference to Article 4, it is understood that when establishing the “place of effective management” as used in paragraph 3 of Article 4, circumstances which may, **inter alia**, be taken into account are -*

⁸³<http://www.thefreedictionary.com/in+substance>

⁸⁴<http://dictionary.reference.com/browse/made>

- *The place where a company is actually managed and controlled,*
- *The place where the decision making at the highest level on important policies essential for the management of a company takes place,*
- *The place that plays a leading part in the management of a company from an economic and functional point of view and*
- *The place where the relevant accounting books are kept.”(emphasis supplied)*

Hence, it appears that the factors considered by OECD commentary, UN commentary and India-Belarus treaty are similar. If the protocol to India-Belarus treaty is understood to be providing general understanding of the term POEM as envisaged by Indian authorities, the same may be made equally applicable to the other treaties⁸⁵ on the basis of parallel treaty interpretation.

The OECD MC (2017 update) has amended provisions under Article 4(3) by virtue of which the POEM may not remain the sole decisive factor in determining the residency for dual-resident persons other than individuals under the tax treaties and the residency of such persons may be determined by the competent authorities under mutual agreement procedure. However, it may still be one of the determinative factors in the mutual agreement procedure. Thus, the OECD Commentary (2017 update) no longer contain the principles/guidance relating to POEM.

➤ **“Control and Management as understood by Indian Courts**

The Commentary by Kanga & Palkhivala i.e. *The Law and Practice of Income Tax* (Tenth edition – page 319) has summarized the understanding of the phrase “Control and Management” by the Indian Courts. It provides that –

“As a rule, the direction, management and control, “the head and seat and directing power” of a company’s affairs is situated at the place where the directors meetings are held and consequently a company would be resident in this country if the meetings of directors who manage and control the business are held here.”

(The expression “control and management”, as understood by Indian Courts is similar as provided in earlier paragraphs of this Chapter)

4.4.2 Understanding Source Provisions provided under Income Tax Law

Developing Countries, i.e. the source country has the primary right to tax the person (resident or non-resident) earning income because the economic activity was carried on from the jurisdiction of such source country.

This understanding is adopted by India by way of specific provisions under section 5 (Scope of total income) and section 9 (Income deemed to accrue or arise in India) of the Act.

- Section 5 [Scope of total income] and analysis

⁸⁵ Reference may now also be made to the domestic tax law in view of amendment to section 6(3)(ii) viz. “Place of effective management” of Income Tax Act, 1961

Section 5(1) provides that total income of any previous year of a resident is chargeable to tax in India from whatever source derived if it is -

- (i) Received or is deemed to be received in India in such year by or on behalf of such person; or
- (ii) Accrues or arises or is deemed to accrue or arise in India during such year or;
- (iii) Accrues or arises outside India during such year.

However, income of a person not ordinarily resident in India shall not be taxable in India unless the income is derived from a business controlled / profession set up in India. An individual person under section 6(6) is considered to be not ordinarily resident in India if he has been a non-resident in nine out of ten preceding previous years preceding that year or during the preceding seven years immediately preceding the current previous year has been in India for seven hundred twenty-nine (729) days or less.

Section 5(2) provides that income of a non-resident shall be taxable in India if it is:

- (i) Received or deemed to be received in India;
 - (ii) Accrues or arises in India;
 - (iii) Deemed to accrue or arise in India – (Section 9 discussed separately subsequently)
- Analysis of income received / deemed to be received / accrues / arises for the purpose of the Act.

Received

Let us understand the concept of what one means by the connotation of expression 'received' with the help of following example -

- Mr. A. of India, an importer of chemicals makes payment to Mr. Chan in China on account of purchase of certain chemicals. Mr. A. has made the payment through his State Bank of India (SBI) Exchange Earners' Foreign Currency Account (EEFC A/C). Up to this stage, income for Mr. Chan is receivable.
- **The income can be considered as 'received' only after he has complete control over the funds** which has been remitted by Mr. A. from India. In this case, it is merely receipt of income from India. However, the income is received in China.

Received in India

Received in India refers to receipt of income in India. Let us consider the following illustration in relation to a non-resident -

- Mr. A, an Indian citizen resides in Germany for employment purposes. His family stays in India. For the purposes of meeting the living expenses, Mr. A requests his employer to pay part of his salary directly to his bank account in India.

In such cases, the part salary which is directly credited to his Indian bank account would be considered to be received in India **since he has acquired control over the part of his salary only after the funds were transferred to India**. Therefore, it would be taxable in India.

Note - Taxability of salary in India would further be subjected to India-Germany DTAA. However, the purpose of this example is to explain the concept of taxability of receipt in India.

Continuing the same example as mentioned above, if instead of directly remitting the part of salary to bank account in India, if Mr. A first receives the salary in foreign country and then remits the salary in India, it would be considered as money remitted in India. Such remittance cannot be considered as income received in India and hence it is not taxable in India if Mr. A is a non-resident.

Deemed to be received in India – Section 7

These are the cases where income is not received in India, but for the purposes of the Act, they are considered to be received in India.

Example

1. Mr. Lionel Messi, an employee of A Ltd. [Spanish WOS Company of A. (India) Ltd.], has been deputed to A. (India) Ltd. In this deputation, he is on the payroll of the Indian Company. Assuming that he has participated in the recognised provident fund⁸⁶, any accretion to the balance of such account would be considered to be deemed to be received in India.
2. If instead of participation in the recognised provident fund, his employer (Indian Government or any other employer) makes a contribution to the account of an employee under a pension scheme referred u/s. 80CCD, the said contribution would be considered as income deemed to be received in India.

Accrues or arises in India

This refers to economic activity carried on in India. For example, if A. Ltd., a company incorporated in U.K is engaged in business of manufacturing and selling mobile phones globally. Considering the Indian market, it decides to set up a branch in India (exchange control regulations are considered to be fulfilled). In such cases, A Ltd.'s income from such activity would be income chargeable to tax in India and A Ltd for the purpose of levy, collection and computation would be considered as a foreign company (tax rate 40%).⁸⁷

The expressions accrues / arises have not been defined under the Income Tax Act, 1961. Therefore, it would not be out of place to look at the dictionary meanings of the terms accrue / arise.

Accrue⁸⁸:-to come to one as a gain, addition, increment, to increase, accumulate, to come into

⁸⁶ In accordance with Provident Fund Regulations

⁸⁷ Taxability of A Ltd is further subject to the force of attraction rules

⁸⁸<http://www.thefreedictionary.com/accrued>

existence as a claim that is legally enforceable.

Arise⁸⁹: - to come into being, to result, issue or proceed, originate.

- **Section 9 [Income deemed to accrue or arise in India]**

Overview of section 9 of the Act: Under the Income-tax Act, 1922, various deeming fictions were provided in different parts of the Act. This had created confusion. Therefore, section 9 of the Act, is an attempt to provide all the deeming fictions under one roof. The deeming fiction attempts to provide the deemed place of accrual rule for the purpose of income-tax in India.

What constitutes source has remained a vexed question. The following questions may arise for the purpose of determination of source –

- Whether the country of market is the source?
- Whether the payer is the source?
- Whether the place from where goods/ services have been provided is the source?

Further, various Court rulings globally had conflicting views which has caused more confusion in the minds of the taxpayers. In order to settle the issue, the law has sought to insert the deeming fictions. However, section 9 per se has been one huge Pandora's Box. In the case of Performing Right Society Ltd [1974] 93 ITR 44 (Cal), it has been provided that *"all income accruing or arising from any 'source of income in India' is deemed to accrue or arise in India.*

The word 'source' does not mean any legal concept, but refers to that which a practical man would regard as a real source of income". (Emphasis Supplied)

Various disputes and litigation have arisen in determination of "source" which do not seem to end. The following are some of the landmark decisions on application or interpretation of provisions of section 9(1)-

- In relation to taxability of a non-resident in India - Ishikawajima Harima Heavy Industries Ltd V/s DIT (2007) (288 ITR 408) (SC)

Ratio of the decision

In order to tax the income in India, services had to be rendered in India as well as utilized in India.

Amendment by the FA 2010 to section 9(2)

It was inter-alia provided that income (Royalty, Interest, and FTS) would be deemed to accrue or arise in India whether or not the non-resident has rendered services in India.

- In relation to Royalty - Asia Satellite Telecommunications Co. Ltd V/s DCIT (2003) (85 ITD 478) (Del.)

⁸⁹<http://www.thefreedictionary.com/arise>

Ratio of the decision

Payments made for using capacity in a transponder for up linking /down linking data do not constitute 'royalty' under the provisions of the Act. The High Court held that the customers did not make payments for the use of any process or equipment, since control over the process or equipment was with the taxpayer and not with the customers.

Amendment by FA 2012 – Explanation 5 and 6 to section 9(1)(vi)

Explanation 5 provides that royalty includes and has always included consideration for 'right, property or information' whether or not –

- The payer has possession/ control; or
- Used directly by the payer; or
- The location is in India.

Explanation 6 provides that the expression 'process' includes transmission by way of satellite, cable, optic fiber or by any other similar technology, whether or not such process is secret.

In view of above, it can be noticed that the law has been amended with retrospective effect to nullify the decisions pronounced by the Courts. The object of our discussion is to analyse the concept put forth by section 9 of the Act. Understanding of the concept is important because only then one can interpret the law in a right way which would help in settling the issues.

➤ Section 9(1)(i)

There are various parts of clause (i) to section 9(1). Let us break the parts to understand the entire clause as a whole. The parts are as follows –

(a) Income from business connection directly / indirectly

'**Business connection**' has been very well explained by The Supreme Court in the case of R. D. Aggarwal & Co (1965) (56 ITR 20). It provides that "*the expression 'business connection' undoubtedly means something more than 'business'. A business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in the taxable territories which contributes directly or indirectly to the earning of those profits or gains. It predicates an element of continuity between the business of non-resident and the activity in the taxable territories. The expression 'business connection' postulates a real and intimate relation between trading activity carried on outside the taxable territories and trading activity within the territories, the relation between the two contributing to the earning of income by the non-resident in his trading activity*".

Further, in the case of Barendra Prasad Ray (1981) (129 ITR 295), The Supreme Court has gone a step further and provided that "*in the phrase in which the expression 'business connection' is used in section 9(1), there is no warrant for giving a restricted meaning to it excluding 'professional' connection from its scope*".

The Finance Act 2018 amended the scope of business connection in order to align the same with the modified Permanent Establishment rule in line with the Multilateral Instrument ('MLI') and further included the concept of significant economic presence. The scope of business connection has been expanded through two set of changes –

- Change in the purview of dependent agency PE; and
- Embracing within the tax net new business models in the digital space by introducing the significant economic presence test

Clause (a) of explanation 2 to section 9(1)(i) has been amended resulting to change the purview of dependent agency PE. Generally, for the purpose of taxing the business income of a non-resident in India, business connection is understood as an activity carried on by a resident on behalf of the said non-resident. However, this may not be the only criteria. The person carrying on an activity on behalf of a non-resident must habitually exercise or have an authority to conclude contracts on behalf of the non-resident or must habitually play a principal role leading to conclusion of the contracts by the non-resident. The ambit of the provision is expanded to situations where a person may not have an authority or the power but may be deemed as a dependent agent even if he habitually plays a principal role leading to conclusion of contracts.

The contracts shall be binding on the non-resident. The contracts shall be-

- in the name of the enterprise or
- for transfer of ownership or granting right to use the property owned by the non-resident or that non-resident has a right to use or
- for provision of services by that enterprise

Also, even if there is no such authority to conclude contracts but the activities carried on by a person of maintaining stock of goods or merchandise from which there is regular delivery of such goods / merchandise is sufficient to establish business connection. Further, business connection may also be established if the agent habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident. However, it has been clarified that a person in India carrying on such activities independently in the normal course of his business is not business connection of the non-resident for the purpose of tax in India. Also, explanation 1, inter-alia provides that -

Clause (a) - in case all operations are not carried on in India only such income must be taxed as is reasonably attributable to the Indian operations.

Clause (b) - Activity of non-resident confined to purchase of goods in India for the purpose of export is not considered to be income deemed to accrue or arise in India.

Significant economic presence

Explanation 2A to section 9(1)(i) was inserted vide Finance Act 2020 (with effect from AY 2022-23) to bring the concept of significant economic presence to constitute business connection in

India and the term "significant economic presence" for this purpose, shall mean—

- (a) transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
- (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed:

Significant Economic Presence will be determined independent of whether the agreement for such transaction or activities are entered into in India or the non-resident has a residence or place of business in India or the non-resident renders services in India. Further, once the non-resident triggers SEP in India, only so much of income as is attributable to the transactions or activities referred to in conditions above, shall be taxable in India.

The CBDT has notified the Income Tax (13th Amendment) Rules, 2021 with effect from 1 April 2022. A new rule has been inserted to provide thresholds for determining the Significant Economic Presence of a non-resident in India.

The Significant Economic Presence in case of a non-resident shall be triggered if (a) aggregate amount of payment for a specified transaction with a person in India exceeds INR 20 million (during a year) or (b) non-resident undertakes systematic and continuous soliciting of business activities or engages in interaction with 300,000 or more users in India.

(a) Income from any property in India

In the case of **Currimbhoy Ebrahim & Sons Ltd (3 ITR 395), 400-01**, the connotation of the expression 'property' is given its usual import as understood in its ordinary sense. It means something tangible; though is not confined to immovable property or to building or land appertaining thereto. **It includes both, moveable and immoveable property (CIT vs. Metro 7 ITR 176).**

(b) Income from any asset or source of income in India

The word 'asset' has not been defined in the Income Act, 1961. However, the dictionary meaning suggests that anything and everything, owned by a person, capable of discharging its debts can be considered as an asset. Further, the expression 'asset' is of wide import to include anything and everything having value as an asset. **The term asset will include all intangible rights, as opposed to property mentioned previously, which covers only intangible property.**⁹⁰

(c) Income accruing or arising through the transfer of a capital asset situated in India'

The provision was introduced to tax any capital gains that a non-resident may make by transfer of any capital asset which is situated in India. This is irrespective of the place where the

⁹⁰ Commentary by Sampath Iyengar's Law of Income Tax (12th Edition, Volume 2, page 1706)

agreement of transfer is made or the consideration for transfer is payable. As per explanation 5 to section 9(1)(i) this clause also covers transfer of shares or interest in a company between two non-resident companies which takes place outside India where the share or interest derives substantial value from assets located in India. This is referred to as indirect transfer. *For a detailed discussion on indirect transfer refer Module C (Article 5 to 31).*

Capital Gains - Vodafone International Holdings B.V [S.L.P (C) No. 26529 of 2010, dated 20th January, 2012]

Ratio of the decision

Tax was not required to be withheld on transfer of offshore assets between two non-residents. The Apex Court followed a “look at” approach thereby upholding the form over substance.

Following the Vodafone ruling, Explanation 5 to section 9(1)(i) was inserted vide Finance Act, 2012 that contains the indirect transfer provisions. Explanation 5 provides that shares of a company or entity registered or incorporated outside India that derive substantial value from the assets located in India shall be deemed to be situated in India.

➤ *Section 9(1)(ii)*

Salaries are taxable in India if the services are rendered in India and the rest period or leave period which is preceded and succeeded by services rendered in India forms part of contract of employment. Withholding tax provisions under section 192 of the Act would be triggered even if the seconded employee is paid salary in his home country by the foreign employer [Supreme Court in the case of Eli Lilly & Co. (India) (P) Ltd. (2009) (178 Taxman 505) (SC)].

➤ *Section 9(1)(iii)*

Indian citizen receiving salary by Government of India for services rendered outside India is considered to be deemed to accrue / arise in India.

➤ *Section 9(1)(iv)*

Dividend paid by an Indian company outside India is taxable in India. (Exemption available under section 10(34) is a different matter altogether)

➤ *Section 9(1)(v)*

Interest income is deemed to accrue or arise in India only if it is payable by (i) Government (ii) A resident for the purpose of business / profession in India or for earning an Indian sourced income. (iii) A non-resident for business / profession in India or for earning Indian sourced income.

Insertion of explanation under section 9(1)(v) of the Act-

With effect from 1st April 2016, if the PE of the non-resident engaged in banking business pays interest to its head office or any other PE of the same non-resident, such interest shall be deemed to accrue or arise in India. This PE is considered to be a separate and independent entity of the non-resident for the purpose of the Act. The interest income is taxable in India in addition to the income of the P.E which is attributable and taxable in India. P.E is defined in an

inclusive manner as a fixed place of business from where business is partly or wholly carried on. However, the taxability of interest income is subject to DTAA and the deduction of interest expense in relation to the P.E will be subject to Indian transfer pricing regulations.

➤ *Section 9(1)(vi)*

This section pertains to taxability of royalty income. The Scope and Definition of 'royalty', chargeability to tax of royalty income of non-residents under the Act, etc. is further subject to Double Tax Conventions. In the present scenario, tax laws are well equipped to tax the income generated from the business of tangible items (example - goods). However, the universe of intangibles, e-commerce, etc. and its taxability have a checkered history and continue to remain so. Various Courts and Tribunals have had conflicting views leading the royalty taxation in India in more troubled waters; adding insult to the injury was the retrospective effect with which explanation 4, 5 and 6 were inserted. Also, taxation of royalties, fees for technical services, etc. seems to be a tug of war between capital importing countries (developing countries like India, China, Brazil, etc.) and capital exporting countries (developed countries such as USA, UK, Germany, etc.) where the developing countries want their own share of pie in the form of tax withholdings. India, in addition to its various reservations to the OECD Commentary in relation to royalty taxation, is responding dynamically by running into huge rounds of litigations. These litigations involve huge costs and the stakes involved are also very high. Further, a wrong interpretation or the negative outcome of the position adopted by the assessee qua royalty taxation has severe consequences such as assessee deemed to be in default, payment of tax with interest, penalties, etc. and also disallowance of the entire expended amount. Therefore, it becomes very important to understand the tax implications in the context of royalty taxation.

Royalty is defined under explanation 2 of section 9(1)(vi) of the Act. The said explanation is as under -

Royalty means consideration⁹¹ for -

- Transfer of all or any rights in respect of patent, invention, model, design, secret formula or process or trade mark or similar property (clause i);
- Imparting of information concerning working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property (clause ii);
- Use of any patent, invention, model, design, secret formula or process or trade mark or similar property (clause iii)
- Imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill (clause iv)
- The use or right to use any industrial, commercial, scientific equipment but not including the amounts referred to in section 44BB (clause iva)

⁹¹ Including any lump sum consideration but excluding the consideration classified as income of the recipient chargeable to tax under capital gains

- The transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films (clause v)
- The rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).... (clause vi)

Royalty income is deemed to accrue or arise in India if it is payable by (i) government (ii) A resident for the purpose of business / profession in India or for earning an Indian sourced income. (iii) A non-resident for business / profession in India or for earning Indian sourced income.

➤ *Section 9(1)(vii)*

This deals with taxation of Fees for technical services (FTS)⁹² in India. Similar to royalty taxation, FTS also has had its own fair share of problems in the Indian context. This is also majorly due to ambiguity in the definition of FTS. FTS under explanation 2 of section 9(1)(vii) has been defined as Managerial, Technical, Consultancy services. Under all the expressions, Indian Courts have used the rule of “Noscitur a sociis” which means that “the meaning of a word is to be found from the context, or a word is known by the company it keeps. The rule therefore involves looking at other words in the same section as the word in dispute or other parts of the Act”. It is a settled understanding that in order to construe a particular service as an FTS for the purpose of Income-tax Act, 1961, the services in the nature of FTS must be provided by a human. In other words, there is a mandatory requirement of human intervention for the purpose of Income-tax Act, 1961. Fees for technical service is deemed to accrue / arise in India if, (i) it is payable by India Government. (ii) Payable by a person resident unless it is for the purpose of carrying on business / profession, earning of income the source of which is outside India. (iii) Payable by a non-resident for the purpose of carrying on business / profession, earning of income the source of which is from India.

➤ *Insertion of new section 9(1)(viii)*

Finance (No. 2) Act, 2019 has inserted a clause (viii) in section 9(1) that deals with income deemed to accrue or arise in India for a person resident outside India. On or after 5th day of July 2019, income arising outside India, being any sum of money which is of the nature referred to in section 2(24)(xviii), paid by a person resident in India to a non-resident (not being a company) or foreign company, shall be deemed to accrue or arise in India.

The provisions of section 2(24)(viii) of the Act provides that sum of money referred to in section 56(2)(x) shall be considered as income.

⁹² The expression ‘Fees for included services’ has been used in the India-USA tax treaty

Principles in relation to section 9(1) –

The following are some of the principles to be considered-

- (i) Mere existence of business connection may not result in income to non-resident assessee chargeable to tax in India.
- (ii) For attracting a taxing statute, there has to be some activity through permanent establishment and, if income arises without any activity of permanent establishment, even under DTAA, taxation liability in respect of overseas services would not arise in India.
- (iii) Permanent establishment and business connection are different concepts. The former is in relation to determining taxability under DTAA and the latter is for application of section 9 of the Act.
- (iv) Location of source of income within India would not render sufficient nexus to tax income from that source.
- (v) Subsidiary Company of non-resident - no automatic consideration as a PE in COS⁹³

In the case of *DIT V/s E-funds IT Solution* (2014) (42 taxmann.com 50) (Delhi), it was held that “*Where an assessee does not have any branch office or factory or workshop in India and merely because it has a subsidiary in India that by itself does not create a fixed place of business / location of PE within meaning of article 5, paragraph 2, sub-clauses (b) to (k) of India-US DTAA*”. The case is affirmed by Supreme Court on 24 October 2017 (2017) (399 ITR 34).

- (vi) Deemed accrual of income is mutually exclusive from real accrual of income.

In the case of **ADIT V/s Adani enterprises Ltd [I.T Appeal NO. 3072 (AHD) of 2009 CO. NO. 291 (AHD) OF 2009]**, it was inter-alia held that deeming of income accruing or arising in India are those situations where income has not actually accrued or arisen in India but still it will be deemed to accrue or arise in India. Hence, both the situations are mutually exclusive. If one case is falling within the ambit of income accrued and arisen in India, it cannot fall within the ambit of income deemed to accrue or arise in India and vice versa.

- (vii) *Deeming concept applies irrespective of business connection which is a general rule, while royalty and FTS clauses are special rules-*

In the case of *CIT V/s Copes Vulcan Inc.* (1987) (167 ITR 884) (Mad.), it was held that “*whether there is a business connection or not, any income by way of fees for technical services should be taken to have been covered by the provision in section 9(1)(vii)*”.

- (viii) *Case falling outside clause (vi) cannot be brought under clause (vii)*

In the case of *Meteor Satellite Ltd V/s ITO* (1980) (121 ITR 311) (Guj.), it was held that “*if the case falls under clause (vi) of section 9(1) and is exempted from the operation of clause (vi) by*

⁹³ Country of source

virtue of the proviso, then one cannot refer to clause (vii) which is a general clause”.

4.5 Conclusion

The law of international taxation is an evolving subject. Not only from the judicial precedence perspective, but also from the viewpoint of legislation, Indian Income-tax amendments are observed closely by various large economies. For example, subsequent to introduction of provisions of indirect transfers in India, China followed India and also introduced the indirect transfer provisions. Various decisions pronounced by the Indian judiciary have been regarded as landmark rulings which have set the trend in the world of international taxation. There are various rules in international taxation which have not yet evolved to a level which can be considered to be a global best practice. This evolution, as a matter of fact, will take time.

5. International Offshore Financial Centres (IOFCs)

5.1 Introduction⁹⁴

In this chapter, an attempt is made to provide an overview on what is an International Offshore Financial Centre and what do we understand by Tax havens. This is so because the two are sometimes considered to be overlapping each other which, having regard to the facts of the case may not be correct.

5.2 Historical Background⁹⁵

During the period of 1960s and 1970s, the historic and distortionary regulations imposed on the financial sectors of industrial countries have largely contributed to the growth of offshore banking and proliferation of Offshore Financial Centers in various parts of the world. The emergence of offshore interbank market during the 1960s and 1970s, mainly in Europe—hence the euro-dollar, can be traced to the imposition of reserve requirements, interest rate ceilings, restrictions as to the range of financial products that supervised institutions could offer, capital controls, and high effective taxation in many OECD countries. This development later was witnessed in markets like Asia, Middle-East, Western Hemisphere, etc.

5.3 Definitions and Classification of International Offshore Financial Centres

5.3.1 Definition provided by the International Monetary Fund (IMF)

The IMF in its background paper on OFCs has defined OFCs. It has been provided that: -

⁹⁴ Various articles, books and computer soft copies have been referred for the purpose of preparing this chapter. However, in particular, the following have been heavily relied upon for the purpose of preparation of this chapter – Basic International Taxation by Professor Roy Rohatgi – Published by Taxmann Allied Services Pvt. Ltd. Chapter No. 111 by Neha Sinha and Ankita Srivastava - 'International Taxation – A Compendium – Volume 3 -3rd Edition' – Published by The Chamber of Tax Consultants.

⁹⁵ Offshore Financial Centers - IMF Background paper in the year 2000.

“A more practical definition of an OFC is a center where the bulk of financial sector activity is offshore on both sides of the balance sheet (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents) where the transactions are initiated elsewhere and where the majority of the institutions involved are controlled by non-residents. Thus, OFCs are usually referred to as-

- *Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents;*
- *Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and*
- *More popularly, centers which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.*

Example

— A. Ltd is a Company set up in Switzerland.

Liabilities

The promoters of A. Ltd are residents of country A with equity capital of say 100,000 Swiss Francs ('SWF').

Business of Company

Company is engaged in business of providing corporate finance and trade in securities listed on the stock exchanges.

Assets

Substantial loans are provided to companies/ residents of country other than those residents in Switzerland.

5.3.2 Classification of Financial Centers

Based on certain characteristics, some of the centres are either regarded as an International Financial Centres, Regional Financial Centres and Offshore Financial Centres. Let us understand these types of centres in more detail.

- **International Financial Centres (IFCs)**

These centres are large financial bodies which provide services of specialized nature in various fields. Some examples of such centres are London and New York. These centres operate in an environment which provides favorable tax and other regulatory policies. The IFCs provide services globally.

- **Regional Financial Centres (RFCs)**

The financial centres provide services which may be restricted to a particular continent. Example:-Countries like Singapore, Hong Kong, etc. provide banking and other allied services including trust administration insurance, tax planning, etc. in Asia. These centres may or may

not be regulated and centres like [Switzerland and Singapore]⁹⁶ have also ensured banking secrecy norms.

- **Offshore Financial Centres (OFCs)**

These centres, although cannot be presumed but they are largely tax driven. They provide limited services of special nature. IFCs and RFCs are collectively referred to as onshore financial centres. The IMF paper has defined OFCs as countries or jurisdictions with financial institutions that deal primarily with non-residents on a scale disproportionate to their size. Some other features of the OFCs include low or zero taxation, less stringent financial regulations, flexible or no exchange control regulations, banking secrecy and anonymity and tax benefits are not available to those who are from outside the Centres, etc.

5.3.3 Some other points for consideration

Considering low costs, including low or nil tax costs, offshore financial centres gained popularity. Many jurisdictions including onshore jurisdictions started promoting such activities and therefore, it became difficult to distinguish between them. Such financial centres are now together referred as International Offshore Financial Centres (IOFCs).

5.4 Tax Havens

5.4.1 History

Most economic commentators suggest that the first "true" tax haven was Switzerland, followed closely by Liechtenstein. Swiss banks had long been a capital haven for people fleeing social upheaval in Russia, Germany, South America and elsewhere. However, in the early part of the twentieth century, in the years immediately following World War I, many European governments raised taxes sharply to help pay for reconstruction efforts following the devastation of World War I. By and large, Switzerland, having remained neutral during the Great War, avoided these additional infrastructure costs and was consequently able to maintain a low level of taxes. As a result, there was a considerable influx of capital into the country for tax related reasons. It is difficult, nonetheless, to pinpoint a single event or precise date which clearly identifies the emergence of the modern tax haven.

5.4.2 Meaning

⁹⁷The term 'tax haven' does not have a comprehensive definition. This is primarily because of the comparative nature of tax benefits provided by any jurisdiction. Because of the relative nature of the advantages provided, every country may be a tax haven to some degree. In this regard, the OECD Tax Haven Report (1997) states that 'any country might be a tax haven to a

⁹⁶<http://www.reuters.com/article/singapore-wealth-offshore-idUSL3N10N1XS20150817>

<https://www.rt.com/business/157148-ban-tax-switzerland-singapore/>

https://en.wikipedia.org/wiki/Bank_secrecy

⁹⁷ Chapter No. 111 of - 'International Taxation – A Compendium – Volume 3 -3rd Edition' – Published by the Chamber of Tax Consultants.

certain extent, as there are many instances where high tax countries provide opportunities or devise policies to attract economic activities of certain types or in certain locations'.⁹⁸ However, to provide clarity, OECD has set out the following criteria (to be considered cumulatively) to determine whether a jurisdiction is a tax haven:

- (i) Whether the jurisdiction imposes no or nominal taxes
- (ii) Whether there is a lack of transparency
- (iii) Whether there are laws or administrative practices that prevent the effective exchange of information for tax purposes with other governments on taxpayers benefiting from the no or nominal taxation.

Transparency is considered a significant criterion as it ensures that there is an open and consistent application of tax laws among similarly situated taxpayers and that information needed by tax authorities to determine a taxpayer's correct tax liability is available (e.g., accounting records and underlying documentation). Similarly, exchange of information in tax matters is important as, the OECD encourages countries to adopt information exchange on an "upon request" basis. Exchange of information upon request describes a situation where a competent authority of one country asks the competent authority of another country for specific information in connection with a specific tax inquiry, generally under the authority of a bilateral exchange arrangement between the two countries. An essential element of exchange of information is the implementation of appropriate safeguards to ensure adequate protection of taxpayers' rights and the confidentiality of their tax affairs.

5.4.3 Current Scenario

- Tax havens are jurisdictions where tax levied in such jurisdiction is low or there is no levy of tax at all.
- There may be various other features due to which a country or a particular jurisdiction may be regarded as a tax haven.
- It may be noted that in certain countries say for example, in India, eligible organizations situated in Special Economic Zones (SEZ) are not liable to tax on certain qualifying income. Such SEZs are tax haven territories within a country like India which otherwise cannot be regarded as a tax haven.
- Another example is that of UAE, a country generally regarded as a tax haven where there is no levy of tax; however, UAE levies tax only on specified sectors of industry like oil and gas producing companies and banking sector companies. Similarly, various countries in order to promote certain sectors provide various incentives including tax benefits.
- **In this backdrop, it becomes very difficult to provide a fixed definition to tax havens. However, the following are the basic characteristics of a typical tax haven**

⁹⁸Basic International Taxation, Roy Rohatgi, Kluwer Law International; 1st Edition (December 21, 2001)

jurisdiction

- (i) Low or no tax on income, capital, wealth, etc. compared to other countries (as provided earlier).
- (ii) Banking / commercial secrecy.
- (iii) Opportunities available for multilateral tax planning.
- (iv) Political or economic stability.
- (v) Lack of exchange controls / dual currency control system for residents and non-residents.

5.5 IOFCS and Tax Havens**5.5.1 Tax Mitigation / Less regulations / Client Confidentiality**

- **Tax mitigation**

Financial services are freely moveable and therefore, this tempted businesses as such to move towards an environment which offers favorable environment to carry out business which had considerably reduced tax bill or resulted in zero tax costs.

- **Less Regulation**

The objective of any regulation is high efficiency and consumer protection. This is achieved by making laws and regulations that provide flexibility which enables carrying out business in a less regulated manner without any additional burden of excessive compliances. While regulations are important, the supervision and enforcement measures are necessary to ensure that the operations are carried out in a satisfactory manner.

- **Client Confidentiality**

A suitable source of information is not available as regards the quantum of transactions carried through the IOFCs, the major reason being, strong client confidentiality norms followed by such centres.

5.5.2 Emerging Favourable Tax Regimes

By the end of the 1990s, the attractions of offshore banking seemed to be changing for the financial institutions of industrial countries as reserve requirements, interest rate controls and capital controls diminished in importance. However, the tax advantages available still remained a powerful incentive. Major industrial countries began to provide similar incentives in their home territory.

5.5.3 Decline in favourable tax regimes for banking business

Supervisory authorities and to some extent tax authorities had started adopting the principle of consolidation which reduced the incentives for banks to carry on business outside their principal

jurisdiction. As a result, the relative advantage of OFCs for conventional banking had become less attractive to industrial countries, although the tax advantages for asset management appear to have grown in importance.

However, important tax advantages continue at a lesser level for banks in comparison with those available with corporate and individual customers. For individuals, the ability to reduce inheritance and other capital taxes seems to have been a prime incentive and led to a large expansion in offshore fund management activity, in particular, by the use of investment vehicles such as trusts and private companies. Industrial and commercial companies were also able to reduce their tax liability through the use of foreign sales corporations to maximize the proportion of their profits that arise in lower tax jurisdictions.

5.5.4 Views in favour of Tax Havens and Offshore Financial Centres

- **Investments in businesses and fast economic growth**

A general commercial understanding suggests that net profit or income is a function of two factors, (i) revenue and (ii) expenditure. Higher the revenue, higher should be the profitability of an organization. Similarly, lower the costs / expenses, higher would be the profitability. In the ever-increasing competition in every sector of the global economy, with difficulty in raising higher revenues, a need was felt to reduce the expenses in addition to finding ways and means of increasing revenue. Since the tax havens or offshore centres provided flexibility to conduct business and various other incentives including beneficial tax regimes, it was observed that it resulted in generation of reserves and promoted investments in other businesses.

- **Tax avoidance is not illegal**

It has been argued that tax liability is something which arises after considering the legal provisions of the enactment and merely stating that avoidance is against the intention of law is not enough. Tax avoidance within the four corners of law by carrying on with arrangements in a manner providing tax benefits is not illegal. This is the uncomplicated difference between tax evasion and tax avoidance. Whether a particular tax avoidance measure is acceptable or not is something which can be ascertained after carefully understanding the factual position and adopting principles such as substance over form, business purpose rule, stripping of the colorable devices used to reduce the overall tax incidence, etc.

Duke of Westminster (1936) AC 1

Lord Tomlin, in this decision proclaimed following –

“Every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”.

- **High tax is a burden on taxpayers and promotes generation of black money**

High tax rate is a burden borne by the taxpayers and the levy of high taxes pinches the taxpayers

especially when overall business environment is not favorable. This heavy burden coupled with poor and below-standard tax administration policies can become the major reason for taxpayers to evade the tax liability. If the overall taxation system is managed in a just and reasonable manner and a simultaneous reduction in the overall tax rate will encourage taxpayers to pay tax voluntarily and honestly.

[Shri Nanabhoy A Palkhivala (more popularly known as Shri Nani Palkhivala), an eminent jurist has said that *“To tax and to please, no more than to love and to be wise, is not given to men, said Edmund Burke over two hundred years ago, and this has been the undisturbed, unchanged truth the world over. In India, where our Income-tax Act is a national disgrace, this profound truth comes home with a keen poignancy to the thinking citizen.”*⁹⁹ [Every government has the right to levy taxes. But no government has the right, in the process of extracting tax, to cause misery and harassment and the gnawing feeling that he is made the victim of palpable injustice’].¹⁰⁰

- **Beneficial to owners of income**

Tax competition is not harmful to taxpayers. It is harmful only to high tax countries who do not receive revenue in the form of taxes. It is not the taxpayers that are to be blamed for a poor tax system; it is the failure of the Government, which without understanding the situation of the overall economy imposes heavy tax burden on its taxpayers.

Supporters for the IOFCs have expressed that reputable offshore financial centers play an important role in international finance and trade. The zero-tax structure allows financial planning and risk management. Further, some of the businesses like financing for aircraft and shipping or insurance, reinsurance, etc. are also carried on through such jurisdictions on account of flexible regulations.

5.5.5 Views against the Offshore Centres and Tax Havens

- It deprives a country which levies a higher tax on the investments and economic development which could have happened considering the other non-tax factors.
- Tax havens are considered as jurisdictions that provide opportunities to non-resident taxpayers to evade / avoid taxes in the home country and / or indulge in activities not permissible under law which leads to loss of revenue which otherwise legitimately belongs to the country which is entitled to its share of revenue.
- Tax havens do not have transparency and they do not co-operate in the exchange of information. Favorable tax treatment is provided to non-residents by tax havens. OECD has defined tax havens as those jurisdictions which make themselves actively available for tax avoidance. The OECD report in the year 1998 also had observed that there exist various “onshore jurisdictions” which provide preferential tax treatments which leads to

⁹⁹ Nani Palkhivala – A Role Model by Major General Nilendra Kumar

¹⁰⁰ Kanga & Palkhivala’s “The Law and Practice of Income Tax” – Preface to the eighth edition by Shri N A Palkhivala and Shri B A Palkhivala

harmful tax competition.

- In the words of Plato, *“Where there is an income tax, the just man will pay more and the unjust less on the same amount of income”*. Use of tax havens is largely for tax evasion which is illegal, and the level of confidentiality offered is just not acceptable. It is a slap on the face of honest taxpayers and makes them to believe that tax and equity are strangers.
- The offshore centres are vulnerable to abuse and organized crime. Quicker formation of companies, electronic transfer of funds, mediocre regulatory standards, assisting terrorist financing, money laundering assistance and other illegal activities are easy from such jurisdictions.

For quite some time, IOFCs and Tax Havens on one hand have been criticised for the tax arbitrage provided which deprives both the developing and developed economies of their share of tax revenue which otherwise belonged to them. In addition to tax advantages, the existence of below-standard anti-money laundering rules enable for easily arranging terrorism financing etc. Confidentiality provided by the tax havens by not co-operating in cases of tax evasion and seeking refuge under their secrecy laws has also been one of the major issues which has made nations act against such tax havens.

5.6 Role of Offshore Financial Centres

Various concessions are offered which is the reason why these offshore centres are regarded as tax havens.

The driving force behind setting up offshore centres may or may not be taxes but it cannot be discarded that they play an important role in business expediency.

OFCs play a major role in the financial system globally. Some facilities provided are as follows-

- (i) Cost reduction, increased revenue through a centralized service to the entire multinational group as a whole.
- (ii) Effective and efficient movement of business drivers such as capital, resources and opportunity to make investments globally.
- (iii) Flexible laws to develop quick legislative solutions to settle the issues.
- (iv) Help intermediary holding companies to overcome strict exchange control regulations
- (v) Help corporations save significant taxes and reduce the impact of transfer pricing rules in home countries.

In the dynamic business environment, it becomes important for businesses to remain flexible which enables to strike at the business opportunities available. This is possible in jurisdictions that do not have rigid exchange control regulations, flexible laws including tax laws and cost saving opportunities, etc.

5.6.1 Tax mitigation is not the only driving force

Offshore centres emerged in the period 1960-1970 due to stringent regulations which made it difficult to carry on business in the home country. Some other key business drivers are as follows:-

- (i) Avoid rigid, unfavorable and onerous exchange control regulations
- (ii) Avoid confiscatory regimes.
- (iii) Protection from legal claims (i.e., asset protection)

5.6.2 Tax beneficial factors

As we are aware that in a cross border economic activity, there are likely chances that domestic tax laws of the relevant two states would be triggered and the receiver of income becomes subject to double taxation. Generally, in order to get relief from such double taxation, one needs to use the provisions of the tax treaty of the country of residence and the country of source, if any.

OFCs levy tax at a low rate or there is no levy of tax at all.

5.6.3 Classification of OFCs¹⁰¹-

OFCs are present everywhere in the world offering preferential tax regime, low costs, high flexibility and adequate confidentiality norms. These OFCs can be classified as follows: -

- (i) **Category – I OFC also known as ‘Base Havens’**
 - (a) Taxes are levied at low or nil rates on certain class of income or on a specified category of persons.
 - (b) The treaties signed by such jurisdictions are few or there do not exist any such tax treaty.
 - (c) The source of revenue for such jurisdictions may be by levying a fee in lieu of taxes or it may charge a flat rate without considering the volume of business activities.
 - (d) No or minimum exchange control regulation, confidentiality of transactions maintained, lack of tax treaties, etc. are some of the common features of such OFCs.
 - (e) It is used as means to stash the income and assets in a manner where taxes are not paid or paid at a very nominal rate.
 - (f) Some income generating businesses which are carried through such jurisdictions are provisions of copyrights, independent personal services, insurance, re-invoicing, shipping business, trading activities, registration of intangibles to generate royalty income; etc.
 - (g) Since there are very limited benefits available, there is only a possibility of deferring the income tax liability but it cannot be avoided. (Source – Roy Rohatgi on Principles of

¹⁰¹ Basic International Taxation – Second edition - Volume II by Professor Roy Rohatgi

International taxation)

(ii) Category - II OFC also known as ‘treaty havens’

- (a) Taxes are levied at a certain rate but with certain incentives or with more flexibility and also there exist tax treaties with various countries and therefore, there also exists exchange of information.
- (b) Further, there may be robust and sophisticated exchange control regulation.
- (c) Tax planning using treaty shopping may be possible through these jurisdictions.
- (d) Taxes, if at all levied, are levied at low rates. These are typical example of a tax efficient jurisdiction. Incorporation of intermediary or conduit companies permits flow of income through efficient means.

Firstly, it is pertinent to note that treaty shopping can be resorted to only if the country intends to allow such measures. However, there may be certain countries which have been victims of treaty shopping notwithstanding their disinclination. To curb such practice, various countries have adopted an anti-treaty shopping measure which reflects / transforms their intention into action. Treaty shopping is carried out by either of the following ways:-

➤ **Direct benefit**

Benefits granted by home and host jurisdiction are availed through the tax treaty.

➤ **Eroding tax base of source country**

In certain high taxed jurisdictions, there may be substantial profits accruing to a multi-national group. By adopting artificial means, say, for example, lending money to the entity just to claim interest expenses in the high taxed jurisdiction for claiming deduction against the taxable income. These interest incomes would generally be taxed at lower withholding rates or not taxed at all in the source country i.e. high taxed jurisdiction.

(iii) Category III – OFC also known as ‘special concession havens’

- (a) As discussed earlier, some countries, which are otherwise not a tax haven, may well be a tax haven for certain specified class of business or transaction to promote such sectors.
- (b) These jurisdictions also provide benefits through tax treaties as well.
- (c) For example, India promoted manufacture and export of goods or provision of services through Special Economic Zones by way of providing various benefits including deductions of export income from total taxable income. The government has developed the Gujarat International Finance tec-city (GIFT) which is conceptualised as a global Financial and IT Services hub, a first of its kind in India, designed to be at or above par with globally benchmarked financial centres such as Shinjuku, Tokyo, Lujiazui, Shanghai, La Defense, Paris, London Dockyards etc. GIFT Master Plan facilitates Multi Services SEZ with IFSC (International Financial Services Centre) status, Domestic Finance Centre

and associated Social infrastructure.

The core objectives of developing IFSC in GIFT Multi Services SEZ are as under-

- To realize the vision of the Government of India to emerge as a major economic power by facilitating development of strong base of International Financial Services in the country.
- Facilitate the implementation of the Government's strategy for the development of a financial hub in the South Asian sub-continent.
- Position the IFSC as a world-class zone for the long-term provision of office/service accommodation and high technological, economical and commercial infrastructure.

Some of the tax incentives announced in the Budget 2018 applicable in case of IFSC are as follows:

- Sale of bond, Global Depository Receipt (GDR), Rupee denominated bond of an Indian Company or a derivative, by a non-resident on a recognised stock exchange located in IFSC shall not to be regarded as transfer provided the consideration is paid or payable in foreign currency.
 - Long-term capital gains exceeding INR one lakh arising from transfer of equity shares in a company or units of an equity oriented mutual fund or units of a business trust to be taxed at the rate of 10 per cent. The rate of 10 per cent is applicable only where Securities Transaction Tax (STT) has been paid on acquisition and transfer of equity shares and on the transaction for transfer of units of equity oriented mutual fund or of a business trust. The STT payment condition is not applicable for transfer on a recognised stock exchange located in IFSC and the consideration for transfer is in foreign currency and in cases of other notified acquisitions.
 - In case of a unit of a Partnership firm or LLP located in IFSC, Alternate Minimum Tax (AMT) is liable to be taxed at the rate of 9 per cent, which is otherwise taxed at 18.5 per cent in case of other companies.
 - Minimum Alternate Tax (MAT) is levied at a reduced rate of 9 per cent of adjusted book profit for companies having units located in an IFSC which derives income solely in convertible foreign exchange where income-tax payable on the total income (according to the normal provisions of the Act) is less than 9 per cent of the adjusted book profit.
- (d) The OECD committee on Fiscal affairs: towards global tax co-operation, pp. 12-14 (OECD, 2000) in its report in the year 2000 has provided a brief description of its member countries for example -
- Preferential regimes for financial services, insurance, offshore banking, mutual funds management and leasing activities to non-residents.

- Permission to set up companies for offshore use with full or partial confidentiality on details of their ownership and transactions.
- (e) However, in the year 2006, OECD progress report viz. “Update on Progress in member countries”, provided that the preferential regimes which were considered as harmful tax competition have now come to an end due to amendments in law or they are abolished completely. However, some of the changes have not been successful in curbing the treaty shopping practices. In the opinion of Jefferey Owens (Director – Centre for tax treaty and administration, OECD) in relation to harmful tax structures, has opined that the changes have “in many cases, encouraged governments to reformulate them, usually by way of the very sophisticated use of holding regimes, trusts, consolidation regimes and tax administration of rules”. Some of the OECD member countries are still regarded as one of the best tax haven nations for certain specified class of activities. Example of such countries also includes US and UK which are otherwise well known for having comprehensive taxation regimes.
- (f) The continued importance of the work on harmful tax practices was highlighted by the inclusion of this work in the OECD’s BEPS Action Plan 5 - Counter harmful tax practices more effectively, taking into account transparency and substance which committed the Forum on Harmful Tax Practices (FHTP) to revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. The FHTP was to continue its work in reviewing preferential regimes wherein the Action Plan 5 report identified 43 regimes out of which 16 were IP regimes.
- (g) Progress report on preferential tax regimes
- In October 2017, OECD released *Harmful Tax Practices - 2017 Progress Report on Preferential Regimes*. This report combines all aspects of the work of the FHTP on preferential regimes since the release of the 2015 Action Plan 5 report. The *Action Plan 5 progress report on preferential tax regimes* includes the review of 164 preferential tax regimes offered by Inclusive Framework members against the Action Plan 5 standard.
- Inclusive Framework members have agreed an ambitious timeline, whereby jurisdictions whose regimes have harmful features are expected to adjust their regimes as soon as possible and generally no later than October 2018.
- (h) The OECD will continue to publish the results of reviews of preferential regimes and the progress that jurisdictions are making to adjust them to reduce the risks posed to tax bases. In its 2018 Harmful Tax Practices - Progress Report on Preferential Regimes, the OECD, as approved by the Inclusive Framework in 2019, found the deductions in respect of certain incomes of offshore banking units and international financial services centres in India to be not harmful.

5.7 Selection of an IOFC

5.7.1 Non-tax factors and Commercial Viability of an IOFC

To carry on business in a manner which enables effective and efficient utilization of resources, the internal and external environment of the organization play a crucial role. In terms of an Offshore Centre, two essential criteria which influence its selection are (i) characteristic of the activity and (ii) characteristic of the territory. Following are some of the considerations required before commencing business activities in any area: -

- (i) Political stability
- (i) Infrastructure facility
- (ii) Availability of manpower
- (iii) Professional services available
- (iv) Competent and trained staff
- (v) Effective and efficient exchange control regulations
- (vi) Easy set up requirements
- (vii) Access to capital markets and sources of finance
- (viii) Easy exit route
- (ix) Efficient banking system
- (x) Ease of transferring money into and out of the efficient jurisdiction

5.7.2 Tax Considerations

The ability of an international group to structure the operations of the affairs of the group as a whole which enables to accumulate reserves for growth and expansion is not unknown. Ideally, it is a desire of any business to function in a tax-free environment. However, this desire to function in a complete tax-free environment is not possible. It is these multinationals and the resources employed by them which possess the ability to structure their affairs in a manner which makes the entire environment tax free or reduces tax costs to a considerable extent. Following are some factors which one may analyse before selecting up an IOFC -

- Tax benefits under domestic laws and tax treaties available in present and also which may be present in the near future.
- Simplicity of the structure and cost effectiveness to justify extra expenses
- Adverse effects of Anti - avoidance measures
- Non-tax benefits and risks in using Offshore centres

5.7.3 Selection of business for an IOFC

In order to set up business in a jurisdiction like IOFC, various factors such as direct and indirect taxes, exchange control regulations, compliance requirements, etc. need careful consideration. The additional costs which the multi-national groups incur must be justified by the benefits it accrues to the group.

- **Holding company**

- ❖ A holding company may be established in a jurisdiction for the purpose of holding and managing investments in the subsidiaries. The holding companies may be either (i) purely holding investments or (ii) also engaged in other activities such as trading, manufacturing, consultancy services, etc.
- ❖ Some non-tax factors which need to be considered before setting up an international holding company which justifies its existence are as follows -
 - (a) Flexibility in group structuring
 - (b) Better co-ordination amongst the entities of the group
 - (c) Freedom from exchange control regulations
 - (d) Ability to access funds from the international markets at a cheaper cost.
 - (e) Availability of solutions to operating issues
 - (f) Ease in communication and maintaining group cohesion.
 - (g) Staff duplication and deputation
 - (h) Lower operating costs
- ❖ Holding companies also enable tax planning. This includes treaty shopping, arrangements which are resorted to avail tax benefits which reduce taxable profits, levy of tax at lower rates on account of taxation of the income on gross basis at lower withholding rates.
- ❖ Some tax considerations which must be considered are as follows -
 - Tax treaties with various countries which enables elimination of double taxation.
 - Low or nil effective tax rates on certain income.
 - No levy of tax on capital and / or net worth
 - Stability in tax laws and treaties
 - Easy tax and corporate compliances requirement
 - Political and economic stability

❖ Some other genuine tax and non-tax considerations

Additional costs

Holding company must be set up when the entire group is incorporated. It may otherwise lead to burdensome reorganization costs.

Capital gains tax, stamp duty, registration expenses-

There are likely chances that subsequent reorganization may result in outflow of funds on various fronts including capital gains tax, stamp duties, registration charges, etc. which may prove to be onerous to the entire structuring activity undertaken.

Exchange control requirements and subsequent changes in the laws governing functioning of holding company

In order to ensure that laws are capable to safeguard the public interest, there is a requirement to frequently change the law which suits the modern economic environment. Therefore, a professional adviser needs to understand the present scenario and also understand the developments that may have an impact on the future planning of the activities of an entity or person.

Genuineness of the holding company

In many cases, residential status is determined based upon the place of effective management. Therefore, one must ensure that the activities proposed to be carried on through an entity in the offshore jurisdiction must be genuine and has a commercial substance with its POEM not in India.

Anti-tax avoidance measures

Various regulations such as (i) Thin capitalization rules (ii) Transfer pricing (iii) Controlled foreign corporation rules (iv) Substance over form approach (v) General Anti-avoidance rules, etc. are some of the methods Governments/ revenue authorities have provided in their domestic tax system. Further, the OECD has also provided some guidelines to curb the practices which are termed as “Harmful tax competition”. If a taxpayer is against the application of these measures, he would have to take recourse to legal remedial measures. While doing so, it has been observed that litigation, irrespective of its outcome, is a costly affair which consumes both precious time and money. Therefore, one needs to be careful that such anti-avoidance measures do not adversely affect the otherwise smooth functioning of the business.

❖ Conclusion

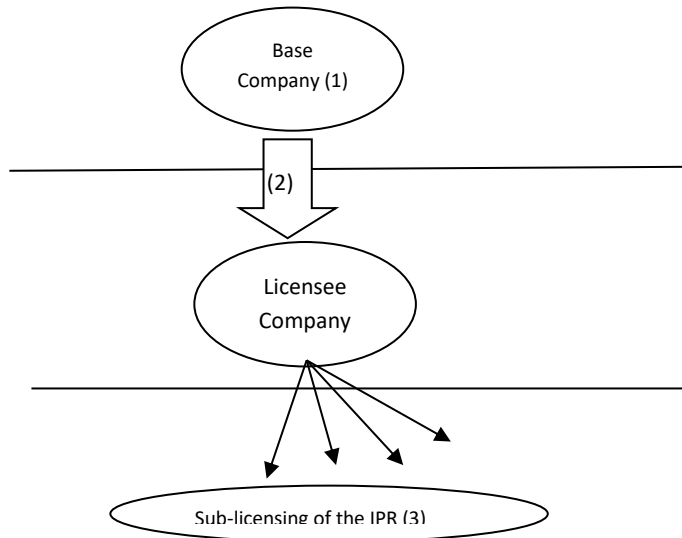
While there are various non-tax incentives which may promote setting up of holding companies in the offshore jurisdictions, one cannot rule out the possibility of using such jurisdictions only to gain an additional tax arbitrage. Nevertheless, international holding companies are set up and used by multi-nationals as means to seek operational and tax benefits. Many countries, intending to promote trade and commerce, encourage people globally including their own residents to carry on such activities.

- **Overseas Finance Companies**

- ❖ Some of the various commercial objectives which can promote setting up a finance company in such jurisdictions are as under -
 - (a) Usage of group funds as per business requirement of the group as a whole;
 - (b) Pooling of resources;
 - (c) Avail finance from the market
 - (d) Function as an intermediary for the purpose of borrowing and lending in strong currency
 - (e) To mitigate the risk of adverse currency fluctuation
 - (f) Function in an environment with flexible exchange control regulations
 - (g) Ease in transferring funds
- ❖ Some of the tax benefits subject to anti-avoidance rules are as follows:-
 - (a) Debt financing and subsequent interest expenses could be claimed as deduction from the pre-taxable income. For such a vehicle, the interest payments, if at all taxable, the rate of tax must be such which involves generally low outflow in the form of tax.
 - (b) These interest incomes or any other income forms part of reserves of the group as a whole which could be used for future growth and expansion.
- **Royalties and Licenses¹⁰²**
- ❖ Under this structuring, the primary motive is generally to seek tax benefits, the use of which helps to achieve the following objectives -
 - (a) Low or nil withholding tax on cross-border royalty payments;
 - (b) Accumulate the income (taxed at a concessional rate in the source country) in a jurisdiction which levies tax at a low rate or does not levy tax at all.
- ❖ The following are the two ways in which tax benefits are obtained –

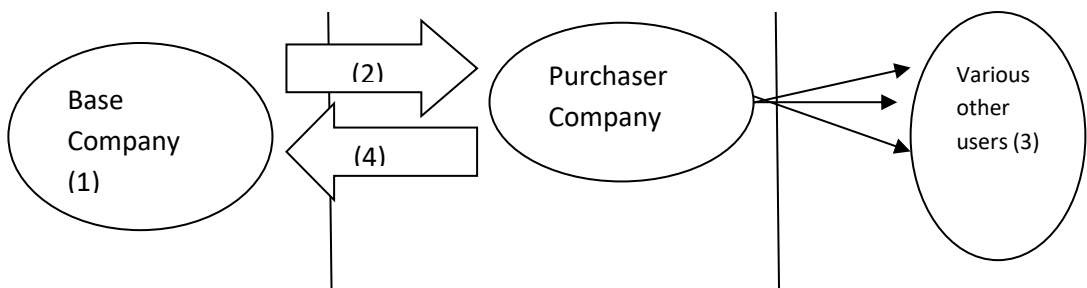
¹⁰²Basic International Taxation Volume II – By Professor Roy Rohatgi

Alternate I



- The base company has acquired the intellectual property rights (IPR)
- This IPR is licensed to a company in another jurisdiction which does not levy tax on outbound royalties.
- The licensee company later sub-licenses to various other users. Tax liability here is reduced since tax on such royalty paid by the user company is generally subject to lower withholding rate and the royalty is allowed as a deduction in computing taxable income.

Alternate II



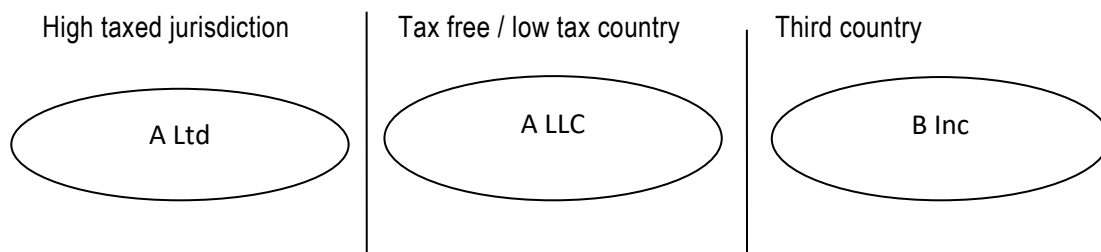
- The base company sells the IPRs to purchaser company
- The consideration payable is treated as a loan.
- The purchaser company earns royalty income from the user companies. Tax levied on such royalty is generally lower on account of the beneficial treaty provisions.
- Purchaser Company pays interest on account of the loan as mentioned in (2) above and claims it as a deductible expense. Also, the purchased royalty is amortised too. The

amortised amount is also allowed as a tax deductible expense.

- **Offshore Trading company**

In this model, a company is generally set up for the purchase and / or sale of goods which in turn enables parking of profits in a low taxed jurisdiction. Since the transaction of such company is with an unrelated party, there is no risk of applicability of transfer pricing regulations. However, there may be a possibility of existence of transfer pricing regulations when the transaction is carried on with related entity. The following are some of the models which are commonly used-

- ❖ **Alternate I – Group Selling Company**



1. A. Ltd, located in a high taxed jurisdiction has the ability to sell the goods to B Inc. However, the sale is routed through a tax-free jurisdiction A LLC. This is primarily done to gain tax arbitrage and reduce the additional taxable income in the high taxed jurisdiction.

2. **A LLC is used for the following two alternatives**

- For re-invoicing** – A Ltd. will sell goods to B Inc through A LLC. The said LLC will invoice the goods to B Inc at a cost plus specified mark up. It is this mark-up of A LLC which escapes taxation in the country of A Ltd. because of structuring of the transaction through an intermediary selling company.
- Selling Agent** – Under this route, goods will be directly sold to B Inc by A Ltd. However, A LLC herein would be acting as a commission agent and / or broker. Such payments would be claimed by A Ltd as a tax deductible expense while computing its own taxable income.

- ❖ **Alternate II – Group Purchasing Company**

Here, the functions of the purchasing company would be to purchase the goods from unrelated parties and sell the purchased goods to the group companies after charging cost plus a certain specified percentage of mark-up.

One important commercial consideration is that since the purchasing company is acting as centralized buyer for the entire group as a whole, it would have more resources to purchase goods at a large scale. This purchase at a large scale will enable the company to purchase goods at competitive prices.

The selling price of the purchasing company becomes purchase cost for the group company which buys such goods from the centralized group buyer. This purchase cost can further be claimed as a tax-deductible expense while computing the taxable income.

Benefits accruing to the entire group due to Group Purchase

Purchase of goods at a cheaper price from the third party due to economies of large scale and substantial purchasing power of the centralized buyer.

(c) Profit charged on subsequent sale of the goods which remain untaxed due to tax benefits available.

(d) Claim of the purchase cost by the company buying from such centralized buyer.

- **Captive Insurance Company**

- ❖ It is an in-house insurance service which enables the group to hedge the unrelated risk.

- ❖ The insurance premiums paid apart from claiming as a tax-deductible expense, is also used by the insurance company to re-invest or for paying the premium to re-insurance companies.

- Various benefits available are as follows:-

- a) Tailor-made policy can be drafted which best suits the needs of the organization

- b) Risk of the group as a whole is reduced by taking re-insurance policies. Further, if the cost for re-insurance is not justified vis-à-vis the benefits available there under, the risk may be reduced to a minimum acceptable level.

- c) The exchange control requirements, insurance norms and other regulations governing insurance business are flexible and enable smooth functioning without additional burden of compliance costs.

- ❖ Jurisdictions like Bermuda, Barbados, Cayman Islands, British Virgin Islands, Luxembourg, South Carolina, Vermont (USA), etc. are some of the examples of such jurisdictions.

- **International Shipping and / or Aircraft Companies**

- ❖ Generally, under various tax treaties, it has been provided that profits from such business shall be taxable in the jurisdiction where the place of management is effectively located. These businesses are generally managed from countries which provide various benefits for carrying out such businesses.

- Following are some benefits available:

1. Low registration fees

2. Minimum regulations

3. Low levy or no levy of taxes

- ❖ Jurisdictions like Panama, Liberia, Bahamas, Cyprus, Malta, British Virgin Islands, etc. are some of the famous jurisdictions for carrying on international shipping, aircraft businesses.
- **Offshore Fund**
- ❖ An offshore fund is generally an organization which carries on business of making investments, mutual funds, etc. These funds collect money from investors and earn income by making investments. These incomes are generally taxed at lower rates. The seller of the unit pays tax on the gain as capital gains tax on sale of the unit.
- ❖ Popular jurisdictions like Bermuda, Cayman Islands, Hong Kong, Ireland, Singapore, Switzerland, etc. are some famous locations for carrying on business in the form of an offshore fund.
- **Offshore Electronic Commerce**
- ❖ Various offshore jurisdictions have provided favourable environment for development of e-commerce activities.
- ❖ E-Commerce has redefined the manner in which business is carried on. The use of internet enables e-commerce activities that do not require physical presence in the source country.
- ❖ E-Commerce businesses are located in jurisdictions where tax is levied at low rate or not levied at all.
- ❖ To carry on e-commerce business, there is a requirement of a server, communication facilities and various other software facilities including ISP, web hosting services, secure transaction facilities, website development, professional advice in relation to company formation and tax advisory and litigation services.
- ❖ E-Commerce has presented a trading model for carrying on business globally without requiring a physical place of business.

Some of the competitive benefits availed of are as follows -

- (a) Low-income tax or no income tax at all
- (b) Flexible regulations enabling effective and efficient planning and control.
- (c) Extra costs involved in operating a fixed place of business is saved.

6. Anti-Avoidance Measures¹⁰³

6.1 Introduction and Brief Background

Brief background

In the late nineteenth and early twentieth century, when foreign trade was expanding, different economies started interacting with each other at different times. However, especially in and around the two World Wars phase (1920-1950), to finance for defense related advancements and also for reconstruction efforts following the devastation caused thereby, almost all the adversely affected economies including UK, Germany, etc. became very high tax jurisdictions which created a very heavy burden on the taxpayers and their livelihood.

This culminated into 3 types of behaviour:

- Tax Evasion
- Tax Avoidance
- Tax Planning

6.2 Tax Evasion / Avoidance / Planning

6.2.1 Tax Evasion

“Taxes and Death” are two certainties of life!!! Tax must be on real income. In other words, someone should not be taxed on notional income. However, in order to reduce the overall tax liability, it has been noticed that a person adopts various means which reduce his taxable income. In other words, artificial situations are created, which results in a gap between the taxable income and the real income. Tax evasion implies culpable mental state or mensrea (guilty mind). This is unacceptable. Harsh repercussions would be experienced when such actions of the assessee are uncovered. It may be noted that a person involved in such offences may also be subject to imprisonment. Some examples of tax evasion methods adopted by taxpayers globally are as follows :-

- (i) Under-reporting of income
- (ii) Claiming deductions in excess of legitimate deductions allowable
- (iii) Non-reporting of economic activities
- (iv) Departure from a country without payment of due taxes

One needs to understand that generation of tainted funds has many adverse effects in an economy. Also, a huge chunk of terrorist activities are also dependent on such tainted funding.

¹⁰³ Various articles, books and computer soft copies have been referred for the purpose of preparing this chapter. However, ‘Basic International Taxation’ by Professor Roy Rohatgi – Published by Taxmann Allied Services Pvt. Ltd. and ‘International Taxation – A Compendium’ 3rd Edition published by the Chamber of Tax Consultants – 3rd Edition has been a major source of reference.

Hence, it is essential that these techniques are discouraged and the guilty is punished.

6.2.2 Tax Avoidance

There is a huge difference between tax evasion and tax avoidance. Tax evasion is very easy to define. Tax avoidance, on the other hand, has many intricacies and it is not easy to identify acceptable tax avoidance and unacceptable tax avoidance. There are two schools of thought where (i) Tax Avoidance is supported by qualifying it as an activity which is undertaken to reduce the overall tax liability within the four corners of law and (ii) Tax Avoidance is not supported by arguing on the premise that it is something which is done contrary to the intention of the legislature.

In the case of McDowell & Co Limited V/s. CTO 154 ITR 148 (1985)

Justice Reddy defined tax avoidance as *“the art of dodging tax without breaking the law”*.

Black’s Law Dictionary definition

Tax avoidance is defined as *“the minimization of one’s tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with evasion, which entails the reduction of tax liability by using illegal means”*. It is also sometimes called as the *“loophole tax planning”*.

OECD on Tax Avoidance

Tax avoidance is an arrangement of taxpayer’s affairs, the intention of which is to reduce his liability which, although is legal, is usually in contradiction with the intent of the law it purports to follow. The European Court of Justice (ECJ) has defined tax avoidance as *“artificial arrangements aimed at circumventing tax law”*.

Intention vis-à-vis Express Language of law

There are a host of decisions which argue that the intent of the taxing statute must be gathered from the language of the law and reference to the Preamble and overall circumstances must be considered in case where the language of the law suggests divergent views. In other words, when the language of the law is clear or when there is clarity in the law, reference to the preamble and overall circumstances should not be given. Further, it has been pronounced by the Courts that it is not within the jurisdiction of the Courts to give a decision which is contrary to the express provision of law. If something is intended to be taxed, it must find a specific place in the statute.

Reference to some landmark cases

- (i) In the case of Lord Vestey’s Executors and Vestey V/s. IRC (1949) 31 TC, 1 HL, p. 90 (UK), it was held that *“Tax Avoidance is an evil, but it would be the beginning of much greater evil if the Courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved”*.
- (ii) In another case of Lord McDermott in Pott’s Executors V/s. IRC (1951) 1 All ER 76 at 88 (HL) 32 TC 11 (UK), it was held that *“It is true that tax evasion may often place the*

draftsmen in great difficulty, but where the draftsmen attempt the prevention of evasion in a manner which may work great harm to innocent people, a decision the Revenue which may encourage the substitution of some better language in taxing section need not be a matter of regret”.

In the Duke of Westminster’s case (1936) AC 1, Lord Tomlin said that “every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”. The decision of the AAR in the context of tax avoidance in the case of Companies Incorporated In Mauritius, In re 1996 (224 ITR 472) is important where the AAR observed that several circumstances have been indicated which induced the setting up of companies in Mauritius and these are certainly relevant considerations. According to the AAR, when there are several relevant considerations which have weighed with the parties to evolve a particular arrangement, it cannot be described as one 'designed, prima facie, for the avoidance of Indian income-tax. The existence of tax concessions under the DTAA was one of the factors taken into account but was not the only, or dominant, object of the transaction.

6.2.3 Tax Planning

While the acceptability of “Tax Avoidance” measures is argued and debated from time immemorial, “Tax Planning” is generally understood in a similar manner by the revenue and the taxpayers. The activity is within the four corners of law without devising any artificial tax planning techniques. It is something which is intended by the legislature.

For example

- A. Ltd. (Indian company) is engaged in business of manufacture of certain goods which are generally imported in India.
- Considering the “Make in India” drive by the Indian Government, various incentives are provided for business organizations globally, like, exemption from import duty on import of raw-materials, exemption from tax for 10 years, subsidies, rebates, land is provided at nominal cost to set up manufacturing plant, etc.
- Considering this and various other commercial incentives provided to various such companies who are manufacturing the said product, the companies may evaluate the profitability in their home country and evaluate the profits if operations are carried on in India and may choose to shift to India.
- In such circumstances, the revenue authorities cannot challenge the business wisdom of the taxpayer and contend that this is a tax avoidance scheme employed to enjoy the tax concessions. The intent of legislature is to grant such benefits and it should be granted accordingly.

Reference to landmark ruling

In the case of Craven (Inspector of Taxes) v. White (Stephen) (1988) 3 All. E.R. 495, it

was held that the revenue cannot start with the question as to whether the transaction was a tax deferral/saving device but that the revenue should apply the look at test to ascertain its true legal nature. It was further observed that genuine strategic tax planning has not been abandoned.

6.3 Overview of Principles Adopted to Implement Anti-Avoidance Measures

Some methods which may be generally adopted for tax avoidance include the following: -

- (i) Deferring tax liability payment;
- (ii) Re-characterisation of an income / expense in order to reduce tax liability;
- (iii) Allocate higher income to jurisdictions which have lower tax rates and allocate low or nil income to jurisdictions which have high tax rates¹⁰⁴

In addition to the above methods, various other methods were identified which enabled the taxpayer to reduce his overall tax obligation. In order to stop revenue leakage, the following anti-avoidance provisions were classified by the Carter Commission Report in four categories which are as follows-

6.3.1 Sniper Approach

Provisions that identify with precision the type of transactions to be dealt with and prescribe against the tax consequences of such treatment [They are in the nature of specific Anti Avoidance Rules (SAAR).]

Example of such SAAR – Limitation of Benefits (LOB) in DTAA, Thin Capitalisation Rules, Transfer Pricing Provisions, Controlled Foreign Company rules (CFC), etc.

6.3.2 Shotgun Method

General Anti-Avoidance Rules which target broad types of avoidance practices in specific areas [Example - General Anti- Avoidance Rules (GAAR¹⁰⁵)]

6.3.3 Administration approach

Responsibility to control tax avoidance is left to the discretion of tax authorities. (Example – Search & Seizure Operations, Surveys and other Compliances)

6.3.4 Arm's length approach

Transactions between related parties must be similar to transactions between unrelated parties under similar circumstances, having regard to commerciality of the transaction. (Transfer Pricing Regulations)

¹⁰⁴ The OECD, to handle such aggressive tax planning techniques has proposed the BEPS project which would target such aggressive tax practices and ensure every country receives its fair share of taxes.

¹⁰⁵ GAAR is enacted in many countries like South Africa, Australia, Canada, India, etc. In India, GAAR is operative from Assessment Year 2018-19

Specific Anti-Avoidance provisions safeguard the tax base of a country. They act as a deterrent and discourage dubious tax avoidance strategies. However, in the absence of SAAR provisions, various Court rulings in India have had conflicting views when it comes to pronounce a ruling qua matters pertaining to tax avoidance. Consequently, taxpayers take up a position which favours them and tax authorities take up a position which would tilt the balance in their favour. Due to this, controversies prevail and there would be different Court rulings. In such an environment, it is imperative that the legislature clarifies the position to settle the issue. However, unfortunately in India, it is seen that the Government waits for the Supreme Court to give its verdict and if the verdict is in favour of revenue then no further action is taken, but if the decision goes in favour of the tax payer then the law is amended with retrospective effect. This has in the past resulted in uncertainty and loss of credibility of the Indian Tax System. The Government in the recent times has committed to a non-adversarial tax regime and has announced that it has decided to do away with introduction of retrospective taxation. To give effect to the above, SAAR provisions may be suitably enacted¹⁰⁶.

In the Indian context, some of the provisions are as follows –

- **Section 14A** (targeting the taxpayer's mischief of claiming expenses incurred for earning tax exempt income)
- **Explanation 5 to section 9(1)(i)** [to discourage tax aggressive strategies – Vodafone Case pronounced by the Supreme Court], etc.
- Section 94 Avoidance of tax by certain transactions in securities
- Section 40A(2) Expenses or payments not being deductible in certain circumstances involving related parties.
- Section 94B Restriction on the interest deductibility in case of funds borrowed from an associated enterprise to 30% of its EBITDA

GAAR provisions on the other hand is sought to discourage the arrangement(s), the main purpose of which is to obtain a tax advantage. In other words, GAAR provisions targets the arrangements which lacks genuine commercial purpose.

On 25th November, 1949, DR. B.R. Ambedkar (father of Indian Constitution), in his Constituent Assembly Speech had said that *“However good a Constitution may be, it is sure to turn out bad because those who are called to work it, happen to be a bad lot. However bad a Constitution may be, it may turn out to be good if those who are called to work it, happen to be a good lot”*.

Similarly, it is accepted that anti-avoidance provisions have a noble intention, it also true that the real success depends on the administrative authorities. Many a times, it has been observed that tax authorities have taken undue advantage of the powers conferred by law which is provided to them to execute their sovereign function. This has led to **“TAX TERRORISM”** by

¹⁰⁶ Such enactments would usually clarify the Legal position and put an end to the issues which had arisen in the absence of specific provisions.

the revenue officials. It should be noted that no action of tax authorities should go beyond the principles of legality applicable, which would otherwise lead to long drawn litigations which is very expensive for both, tax department and assessee as well.

Therefore, it needs to be kept in mind that Anti-Avoidance measures are enacted for a specific purpose and the purpose is, to safeguard the tax base and it is not a mechanism to raise revenue.

6.4 Judicial Precedents

6.4.1 A Holistic Approach

- **In the case of Bhoruka Engineering Industries Limited V/s. DCIT [ITA No. 120 of 2011] – Taxsutra.com it was held that -**

“The legal right of the taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them by means which the law permits, cannot be doubted. As long as the arrangement of the taxpayer to avoid does not contravene any statutory provision and is achieved within the four corners of law, it cannot be found fault with. If the transaction in question is a sham or colorable, and entered into with the sole intention of evading payment of tax, then such a transaction would not have any legitimacy. Therefore, in each case, the transaction in question and the material on record has to be carefully examined to find out whether the transaction is ‘sham’ or ‘unreal’ or ‘colorable device’ to evade payment of tax”.

- Therefore, one can infer that in India, a taxpayer is entitled to plan his affairs in a manner which is tax efficient. However, such a mechanism adopted must clearly be within the four corners of law and use of any sham or unreal or colorable devices adopted to defeat the provisions of the law must be disregarded and the provisions of the law shall prevail eventually. However, in some cases, the legal form has prevailed over the substance of the transaction.
- Further, from observation of the recent trend, it seems that the purposive doctrine is now being used to counter the cases of unacceptable tax avoidance.
- For instance, Article 12 of India-USA DTAA provides that the beneficial owner of Royalty must be resident of the contracting state.
- Similarly, one can also find the term ‘beneficial owner’ in various other articles of Indian DTAA’s which clearly states that it is the real owner who qualifies for availing of the benefits of the DTAA and not just the legal owner. This effectively enables to counter the treaty shopping practices.
- Such principles have been the root for emergence of GAAR provisions. There are various other countries which have also pronounced judicial rulings based on principles like the substance over form. Netherlands, Argentina, Austria, France, Germany, etc. are some examples of such countries.

6.5 Look Through Approach for Transactions Which do Not Have Any Commercial Motive

As a general understanding, it is well known fact that business is carried on to gain commercial advantage. Tax is a levy by the country on the profits / income. In an ideal business environment, the business may forgo the tax benefits but it definitely cannot overlook the commercial hindrances which might come in the way of carrying on business. Therefore, under this approach, it is the non-tax expediency which must be established beyond any doubt. It is only then the transaction is considered and is not a colorable device adopted to seek tax benefits only.

A correct balance between tax and non-tax factors must be struck. In the case of Gregory V/s. Helvering 293 US 465 (1935)(US), it was held by the US Supreme Court that transactions undertaken purely to obtain tax advantage cannot be qualified for tax benefits. It was further held that *“In construing words of a statute which describe commercial or industrial transactions, we are to understand them to refer to transactions entered upon for commercial or industrial reasons and not to include transactions entered upon for no other motive but to escape taxation”*.

The business purpose rule provides that it needs to be evaluated whether in the absence of any tax incentives, would the transaction still be carried on? If the answer is yes, it satisfies the business purpose rule and if the answer is no, it may be difficult to escape from the clutches of GAAR / SAAR, as the case may be.

6.5.1 (A) Recognition of “Form and Substance” for taxation purpose and (B) Concept of Substance over form

• Form and Substance

It is a debate going on from time immemorial that what should prevail, **“Form or Substance”**?

Form is the character of a particular transaction defined by statute, courts or regulations. Substance is defined as either economic (where it is based on commercial considerations) or legal substance (understood from rights and obligations and arising from a legal relationship). In other words, “Form” is how a structure/ arrangement looks like and “Substance” means what the transaction in reality is.

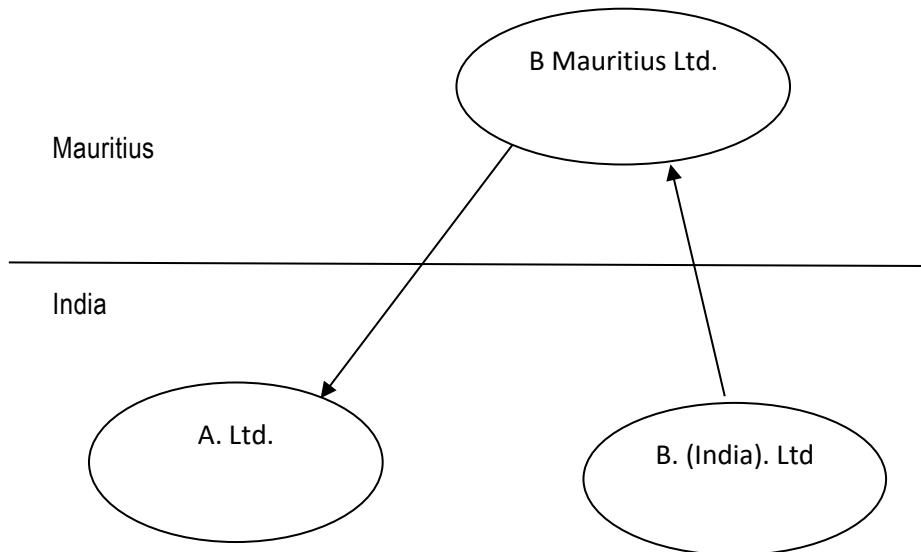
• Concept of Substance over form

In relation to the concept of substance over form, OECD provides for “the prevalence of economic or social reality over the literal wording of legal provisions¹⁰⁷.”

(i) To understand this, let us consider the following hypothetical illustration which was being structured to take the advantage under Article 13(4) of the India Mauritius tax treaty. The India-

¹⁰⁷ Committee on Fiscal Affairs: International Tax Avoidance and evasion through the use of tax havens (OECD, 1987)

Mauritius tax treaty has been amended with effect from 1 April 2017¹⁰⁸ by virtue of a Protocol which has been signed by the two countries on 10 May 2016. This amendment gives India the taxation rights on capital gains arising from alienation of shares in a company resident in India acquired on or after 1 April 2017 with effect from FY 2017-18. In respect of such capital gains arising during the transition period from 1 April 2017 to 31 March 2019, the tax rate will be limited to 50 per cent of the domestic tax rate, subject to the fulfillment of the conditions in the Limitation of Benefits (LOB) Article in the Treaty. Taxation in India at full domestic tax rate will take place from FY 2019-20 onwards. The existing investments i.e. investments made before 1 April 2017 have been grandfathered and will not be subject to capital gains taxation in India.



- In the above case, A Ltd. and B Ltd. are Indian unlisted Companies engaged in the business of manufacturing automobiles.
- B. (India). Ltd intends to acquire substantial shareholding in A. Ltd. but with intent that it must be a tax efficient structure
- For this tax efficiency, B. (India). Ltd had set up a WOS subsidiary in Mauritius whose business is to hold investments in various companies. Being a newly set up company, it did not have funds to acquire a stake in A. Ltd. Therefore, B (India) Ltd funded B Mauritius Ltd.
- The above structure has been selected mainly because B Ltd wants to take advantage of Article 13(4) of the India-Mauritius tax treaty. With Article 13(4) in place, capital gains on account of transfer of shares by a Mauritius resident (B

¹⁰⁸ Except for the article on Exchange of Information and Assistance in collection of taxes where the effective date is 19 July 2016.

Mauritius Ltd) of an Indian company (A Ltd) will be taxable only in Mauritius. Further, there is no capital gains tax in Mauritius. Thus, it helps to achieve double non-taxation.

- If, B (India) Ltd had directly acquired shares of A Ltd, a subsequent transfer of shares of A Ltd would have had capital gains implications. The structure (form) adopted here is that of a Mauritius route by an Indian resident to avoid Capital gains tax liability. The structure of such a route could be only to take tax advantage available under Article 13(4) of India-Mauritius DTAA.

6.5.2 Sham Transactions

It is a very well-known concept. In reality, it is purely a fraud which can only be discovered after adopting the substance over form methodology.

For example, in a typical **“Entry Transaction,”** a businessman has accumulated huge wealth from his business activities. He is the owner of a huge sum of money which is from undisclosed sources which obviously have never been taxed. This person is in need of funds to carry on his business activities but for carrying on business activities, this money is required to be infused into his business through banking channels. In order to arrange funds for his business, he pays cash to a relative and receives this cash back through a cheque. The legal form given to such an arrangement may be that of a loan at x% interest rate. Subsequently, this money may be used for business purposes. Further, on such tainted loans, he would pay interest and claim interest deduction.

In India, under the Act, section 68 is well equipped to tax such tainted money and further proceed to disallow the claim of interest expenses but in reality, it is very difficult to trace the trail of such transactions.

By and large, it depends on the effectiveness of the techniques which may be adopted by the assessing officer which reveal that the facts deviate from the legal form which it has got from the contracting parties.

In such transactions, the parties never intend to create legal rights and obligations since there does not exist any such relationship which may give rise to the creation of such rights and obligations.

6.5.3 Principles of Jurisprudence in Tax Laws

- **Introduction**

Law is enacted by Parliament of a country according to its wisdom. To achieve the purpose of the law, it is left to the Government to ensure proper and just administration and functioning of the law in the legal system. The purpose of the Act can be known by reading its preamble.

The provisions of the Act are interpreted by the Court of law at the time of pronouncing a decision. It is a general observation that the court interprets the law the way it ought to be interpreted. Therefore, the *“ratio decidendi”* which comes out from the legal decision also finds

its place in the legal system of a particular country.

Under the taxing statute, there are a host of decisions which suggest that (i) the Courts must pronounce decisions keeping in mind the language of the Act, purpose of the Act, and the overall circumstances which may have a bearing on the functioning of the Act. (ii) Courts must give decisions only from interpreting the language of the law and the intention must be gathered from its language. If something specific is sought to be included within the ambit of a taxing statute, it must find its place specifically in the statute.

With this understanding, let us try and understand some of the principles adopted by the Courts .

- **Doctrine of “Abuse of right” (Abus de Droit)**

The people of India can enjoy the rights given to them by the supreme authority .i.e. **“The Indian Constitution”**. However, the exercise of the rights shall in no way have its effects which are contrary to the public policy. The right to levy, compute and collect taxes is empowered to the State by the Constitution. Just as our homes need money to manage the day-to-day affairs, similarly, taxes are required to be collected by the Government to manage the affairs of the country. No right shall be exercised by a person to defeat the purpose, intent and the provisions of the law. The Courts have pronounced decisions in favor of the State and against the person who has exercised his right against the purpose, intent and to defeat the provisions of law.

Similarly, in tax cases, in case of conflict between the taxpayer and the revenue, it is the Appellate Authorities of a country who have to decide as to what action must be taken in order to safeguard the purpose, intent and the provisions of law. Where (i) legal form adopted and (ii) the arrangement carried on, appears to be a mechanism adopted only to gain tax benefit and defeat the provisions of the taxing statute, the Courts have disregarded the legal form adopted and decided in favour of the revenue.

6.6 Anti–Treaty Shopping Measures

6.6.1 Introduction

Treaty shopping activity refers to a situation where a resident of a third country, i.e. Mr. A. of Country A seeks tax benefits from the Double Tax Convention which is between Country B and Country C. Let us understand this concept with the help of the following example.

- A person Mr. A resident of a Country A earns income or may earn income from a Country C (source country) which is a high taxed jurisdiction and the tax treaty does not favour Mr. A or there is no tax treaty between Country A and Country C.
- As tax in the country of source is a cost, Mr. A is in search of possible tax cost reduction. He approaches a tax consultant who advises him that the exchange control regulations of his resident Country A permit its residents to set up companies outside Country A for purposes of business.
- Mr. A therefore, floats a company B. Ltd in Country B. The decision of setting up a company in Country B is because the tax treaty between Country C and Country B taxes the income of residents of Country B at a low rate.

Subsequently, Mr. A may or may not repatriate the profits of B. Ltd to his home country i.e. Country A. In other words, he may enjoy the low taxed profits as per his own whims and fancies.

6.6.2 Effects of Treaty shopping

- **Advantages of treaty shopping**

There are various countries that support such strategies in order to attract business which ultimately results in development of their markets both, domestic as well as overseas. Treaty shopping carried out for non-tax commercial purpose helps in integration of a single market where multiple people of multiple countries may become a part of such huge single integrated market.

- **Disadvantages of treaty shopping**

On the other hand, several countries are not happy with such strategies. The major reason for disgruntlement is that such countries at the time of signing the tax treaty had never intended to extend such benefits to the residents of a State other than the Contracting State. Another reason is that it has resulted in contraction of the tax base of the countries due to such treaty shopping practices. In order to counter such tax practices, some countries have adopted measures which act as a deterrent and curb the treaty shopping activities. For example, some countries like India would levy tax on the offshore subsidiaries of its residents subject to the determination that the **“Place of Effective Management (POEM)”** of such offshore subsidiaries is in India.

6.7 OECD on Treaty Shopping Policies and Measures to Counter Treaty Shopping Practices

Double Tax Conventions are agreements entered into by two countries who wish to grant relief from double taxation in order to promote mutual economic relations, trade, investments, etc.

To interpret tax treaties correctly, one must understand and keep in mind the principles required to interpret an agreement.

Contracting parties, by entering into an agreement, give effect to the specific purpose and intention. Therefore, if a particular Contracting State had never intended to promote treaty shopping practices at the time of entering into the agreement, effect must be given to the intention even if the provisions permit tax benefits.

OECD had expressed its views against the treaty shopping practices carried out by taxpayers globally. It states that treaty shopping is undesirable since it frustrates the spirit of the treaty, if not the provisions. The following are some of the measures which were adopted to curb the treaty shopping practices:-

- i. The person intending to seek treaty benefits was required to qualify as a resident as per Article 4(1) of the MC. This means that the person intending to seek treaty benefits must be a resident of a country which taxes the global income of the resident. Therefore, the liability is as per the normal rates / full rates.

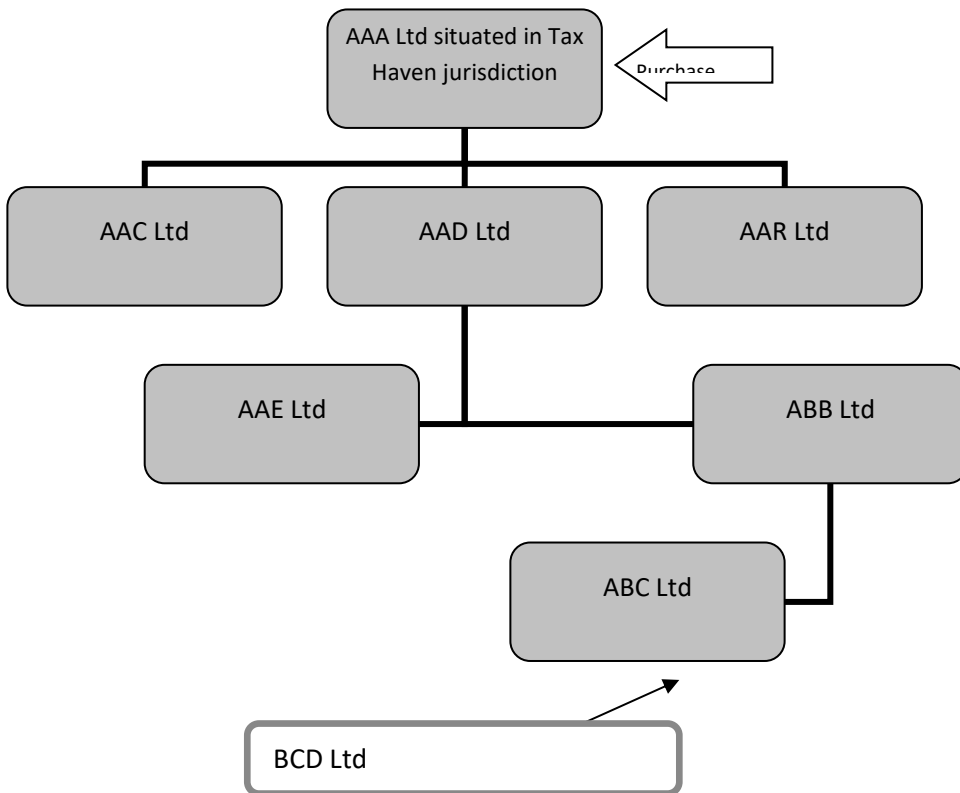
ii. Look through approach

Article 10 – Dividend income taxation, Article 11 – Interest income taxation, Article 12 – Royalty income taxation, etc. provide that it is only the beneficial owner who is eligible for the treaty benefits. Therefore, one can say that is the real economic owner who genuinely is a beneficial owner of the income and actually a resident of the Contracting State who can avail of the treaty benefits.

iii. The structure of the taxpayer must have sound business reasons and the structure must not be adopted just to avail of tax benefits.

Example- Structuring to obtain tax efficiency without sufficient business reasons

Tax Haven Jurisdiction



Target Jurisdiction

- A company AAA Ltd is situated in a tax haven jurisdiction.
- The entire group (Group A) is structured and designed in a manner where treaty shopping practice has accrued tax benefits to the group as a whole.
- Through its various subsidiaries and other group companies, the company AAA Ltd which is situated in a tax haven is exercising control over a company ABC Ltd which is a healthy profit-making company. ABC Ltd is the back-bone for the net worth of Group A as a whole.

- There is no tax treaty between the country (high taxed jurisdiction) of ABC Ltd and the tax haven jurisdiction.
- All the intermediary companies of Group A are set up to avail of tax benefits only. These intermediaries would have never been set up had there been benefits directly available by way of tax treaty between the said high taxed jurisdiction and tax haven country.
- Another unrelated company BCD Ltd of Group B situated in a country other than the aforementioned high taxed jurisdiction intends to acquire a controlling stake in ABC Ltd of Group A.
- Company ABB Ltd of Group A is the immediate parent company of ABC Ltd holding 75% of the total share capital.
- If BCD Ltd acquires shares of ABC Ltd from ABB Ltd, then as per the tax laws of country of incorporation of ABC Ltd, there is a withholding obligation on the part of BCD Ltd at the time of payment of purchase consideration to ABB Ltd.
- In order to avoid the withholding tax obligation in the country of incorporation of ABC Ltd, Group A plans the entire transaction wherein BCD Ltd will acquire stake in AAD Ltd or AAE Ltd or ABB Ltd which enables to exercise control over the affairs of ABC Ltd as desired.
- Since the real substance is of acquiring a controlling stake in ABC Ltd, the valuation of the purchase consideration is based on the assets of ABC Ltd.

Tax treatment of structuring as above

Firstly,

Treaty shopping, since it is against the principles of Double Tax Conventions, all the benefits shall be disregarded and the tax should be recovered from Group A as a whole. The recovery shall be as per the provisions of tax laws of the jurisdiction which would otherwise have the right to tax such profits. In other words, the country which is adversely affected by the treaty shopping and has the legitimate right to tax the transactions of Group A must recover taxes accordingly.

Secondly,

The real economic substance of the above share purchase transaction is for acquiring control over the business of ABC Ltd and therefore, the '**sham**' intermediaries must be disregarded. Therefore, tax must be levied and there should be a withholding obligation on the part of BCD Ltd.

Tax treaties are signed to eliminate double taxation. Any unacceptable tax avoidance planning and / or tax evasion must be disregarded.

Treaty benefits must be granted under the principle of *pacta sunt servanda* (in good faith). Under the principles of International Tax law, every provision of tax treaties is generally binding on the Contracting States and it overrides the domestic law if the treaty is more beneficial. However, it must be noted that in order to claim the benefits of tax treaties, the transaction must be genuine. Only and only then, the principle of *pacta sunt servanda* is met with.

Commentaries to OECD MC

Under Paragraph 7 of Article 1

The paragraph 7 of Article 1 suggests that in addition to eliminating the brunt of double taxation, tax treaties shall also curb the practices due to which the tax base gets eroded. Therefore, now, in addition to domestic laws, even treaties could contain measures to curb the practices which were carried on for the sole reason being avoidance of tax liability. (Example – Limitation of benefits, Beneficial Owner clause, Thin Capitalisation, etc.)

6.8 Controlled Foreign Corporation (CFC)

6.8.1 Introduction

Under the resident rule of taxation of a country, global income of the resident may be subject to tax in the country of residence. The residential status of a person by itself is sufficient to subject a person to taxation. It needs to be noted that in order to avoid taxes in the resident country, people had set up corporations outside their resident state in a jurisdiction which would not levy tax or levy tax at a lower rate on the foreign sourced incomes. These incomes would be brought back to their country in a manner where tax levied would be lower.

6.8.2 Let us consider an example

- (a) Mr. A (high net worth individual), a person resident of Country A was earning foreign sourced income from Country B.
- (b) His global income is taxable in Country A at say 30%.
- (c) In order to reduce his tax liability in Country A, he set up a company in Country C and diverts his foreign sourced income to this company.
- (d) Country C levies tax only if the income is sourced from Country C.
- (e) Therefore, effectively, the foreign sourced income of Mr. A is taxed only in the source country B and therefore he can continue accumulating his wealth in Country C.

6.8.3 Anti-Avoidance provisions in relation to CFC provisions

To counter the practices adopted to avoid taxes in Country C, Controlled Foreign Corporation rules are introduced. Accordingly, if CFC provisions are present in the domestic taxation system of Country A then, the income of Mr. A. from Country B will be taxable in Country A at 30%. Relief from double taxation may be available subject to DTAA between Country A and Country B. In the absence of DTAA between Country A and Country B, unilateral relief may be available as per the domestic tax laws of Country A.

Further, it may also be interesting to see if the penal provisions are applicable or not. A penalty may be imposed on income which is concealed.

6.8.4 Constitutional validity of CFC Rules, if applicable – From an Indian perspective

Let us have a look at Article 245 of Indian Constitution

245. Extent of laws made by Parliament and by the Legislatures of States

(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State

(2) No law made by Parliament shall be deemed to be invalid on the ground that it would have extra territorial operation. (Emphasis supplied)

On the above analysis, in order to protect the Indian tax base, it appears that any provision of the Act, which could possibly be inserted or amended having extra territorial operation cannot be regarded as unconstitutional. The elementary reason being that the income has nexus with India.

6.8.5 Basis for regarding an entity as a CFC

In order to classify a particular corporation as CFC, the degree of control must be equal to or exceed the specified threshold limit as provided under the CFC governing legislation.

Control in relation to a company under ordinary circumstances means the power to dictate. This may be due to equity ownership, voting control, ability to share profits. This is more or less direct in nature. However, even indirect abilities may also be considered for applying the CFC rules.

Control

a. More than 50% equity or voting power

In some countries, the condition of control may be satisfied only when a particular company owns equity or has voting power, directly or indirectly, in excess of 50% in the other company.

b. Equal to or less than 50% of equity or voting power

In some countries, the condition of control may be satisfied even when a particular company owns equity or has voting power, directly or indirectly, equal to or less than 50% which is deemed to be sufficient to dominate and / or possess the ability to reduce the overall tax liability.

Approaches adopted to tax CFC income

As seen from the above, CFC is a Specific Anti-Avoidance rule which is incorporated in various countries to curb the practice of shifting income from one tax jurisdiction to another jurisdiction. The primary intention appears to target the use of low tax jurisdictions where income is parked to reduce the overall tax liability in the home country where the taxes are levied at a higher rate. The following are some of the methods to tax the income of a CFC:-

i. Income from a specific location

All the countries have a right to tax their subjects according to their own wisdom and having

regard to the economic situation of the country. Ideally speaking, if a particular country is a tax haven, it does not mean it must be looked with arched eyebrows. Some countries in spite of levying low tax or no tax at all may have sophisticated taxation system, sufficient KYC norms, and co-operative approach at the time of sharing of details of information of assets/investments made by residents /citizens of the country making the requisition. Such countries must be considered as White listed category jurisdictions. However, there also exist such jurisdictions which must be blacklisted and CFC rules must be applied by using techniques such as substance over form, look through approach, business purpose rule, etc. Accordingly, it is important to classify countries into various categories.

One may say that white-listed category jurisdictions which do not assist tax evasion / unacceptable tax avoidance must not be doubted subject to satisfying the substance over form principle, business purpose test and other Anti-Avoidance rules including Transfer pricing regulations.

ii. Income specific CFC legislation

Under this mechanism, tax is levied on the specified income of a resident shareholder. The target is to tax certain passive income such as income from investment, income from properties owned by the foreign corporation of which the residents of a jurisdiction are shareholders. Here, on fulfilling certain conditions, CFC legislation presumes the shareholders are acting in a malafide manner by allocating profits to a low taxed jurisdiction and such income is deliberately intended to be parked outside the home country to avoid taxes thereon.

Certain active income may also be subject to taxation on satisfying certain conditions. For example, in some countries, residential status of a corporate entity is dependent upon the place of incorporation or its place of effective management (example – India). Therefore, if the place of effective management of a wholly owned subsidiary say ABC Ltd (incorporated in a low tax jurisdiction) of A. Ltd (an Indian resident company) is found to be in India, the entire profits of ABC Ltd will be taxable in India. Further, being a resident, ABC Ltd would be required to file its return of income, deduct tax at source on specified payments, furnish TDS statements, get its books of accounts audited from an accountant as per section 44AB of the Act, and further, also comply with Indian Transfer pricing regulations etc.

India-USA DTAA

Article 4(3) of India-USA DTAA provides that if a company, by reason of the provisions of the tax laws of the two states is considered to be a resident of both the contracting states, such company would not be eligible to claim the benefits provided under this DTAA except for certain articles under the DTAA viz. Non-discrimination, Mutual Agreement Procedure, etc.

CFC in India

CFC provisions were proposed to be introduced in India under the erstwhile Direct Taxes Code, 2010 which was to replace the existing Indian Income Tax Act, 1961. These provisions were introduced to limit artificial deferral of tax by using offshore low taxed entities. On the basis of

an Expert Committee's¹⁰⁹ suggestions to comprehensively review the DTC, the government of India proposed a revised DTC, 2013. However, since the Direct Taxes Code was not enacted, the CFC provisions has not seen the light of the day.

The CFC recommendations now, are a part of the BEPS Action Plan 3 Report which have been discussed in Module B dealing with Principles of International tax Laws.

6.9 Thin Capitalisation

6.9.1 Introduction

“Capital” in commerce is generally understood as owned funds available with a person to carry on business activities. However, business today is also being carried on by availing debt funds. Debt funds generally come with a service cost in the form of interest which needs to be paid as per the terms and conditions mutually agreed upon between the contracting parties. The interest cost does not belong to the owners of business. Interest expense on owed funds which are used for business purposes is allowed as a deduction while computing the taxable income. Further, there may be a withholding obligation at the time of payment to the payee on the part of the interest payer.

Equity or owned funds in a business also carries a cost. This cost is in the form of dividends on which, there may be a withholding obligation or a dividend distribution tax liability which has to be discharged as per provision of the law. Generally, payments of dividends are not allowed as a deduction while computing the taxable income of the taxpayer since dividends are paid to owners of the funds. In some countries, there is a levy of tax on the net worth of a person. However, debt funds cannot be considered as wealth of the taxpayer and therefore, it escapes from the net wealth taxation.

6.9.2 What is thin capitalisation?

The Committee on Fiscal Affairs: Issues in International Taxation No. 2 – Thin Capitalisation of the 1987 OECD report refers to thin capitalisation as “hidden equity capitalisation”.

Compared to equity funding, debt funding is a tax efficient structure. Debt on one hand is deductible in the hands of the payer and on the other hand, the interest on such debt is taxed at a lower withholding rate. Such low withholding is on account of the DTAA provisions.

Consider the following example –

- Company A from USA floats a subsidiary in Indonesia. Now, instead of funding it through equity, Company A gives USD 100 (\$) as loan against equity of USD 10 (\$).
- As interest paid by subsidiary is tax deductible, it would save corporate tax in Indonesia (say 25%) and the interest income in the hands of Company A would be taxed only @ 10%. Dividends on equity leads to economic double taxation, whereas interest payment

¹⁰⁹ Kelkar Committee's report on the 'Road Map for Fiscal Consolidation'

does not result in any double taxation, instead it leads to saving in taxes.

6.9.3 Thin Capitalisation Rules

From the above illustration, one may conclude that such a structuring may be made with a prime object of availing tax benefits. Under business purpose test, this arrangement may fail. Under the thin cap rules, debt in excess of acceptable limit (provided under law) may be considered as equity and the interest on the artificial debt, although true under the legal form, may be disallowed and the said interest be re-characterised as dividends.

In some countries, there are specific thin capitalisation rules adopted by the governments of the respective countries which discourage such profit shifting activity and entitles the source country or the resident country, as the case may be, to re-compute, levy and collect due tax from such artificial arrangements.

Various countries that do not provide for such rules restrict the excessive debt by imposing exchange control restrictions, suitable transfer pricing regulations, general anti-avoidance rules, etc. In India, External Commercial Borrowings (ECB) regime provides that the ECB availed will be subject to ECB liability: equity ratio of 7:1 under the Automatic and the approval route¹¹⁰.

6.9.4 Open market approach

Taxpayers might artificially arrange loan in any form to avoid taxes. In the open market approach, debt raised from a related party is benchmarked on an arm's length principle from the perspective of thin capitalisation rules. One may adopt a business purpose rule or substance over form approach. By this, one may analyse that (i) whether an independent third party in similar circumstances would have provided such loan to the borrower? (ii) Whether the interest rate would be acceptable in arm's length transaction (iii) Are the repayment terms and conditions acceptable.

6.9.5 Debt: Equity – fixed ratio approach

In such circumstances, considering practical issues and difficulties which may arise in the open market approach, in the absence of an appropriate comparable, certain jurisdictions have adopted a fixed debt: equity tolerable ratio limit for the thin capitalisation regulation. If the ratio exceeds the acceptable tolerance limit, it is the taxpayer who has to prove the genuineness of such debt which may otherwise result in disallowance of interest, re-characterization of interest as dividend, debt funds may be regarded as equity and may also be subject to exchange control regulations if the re-classified debt exceeds the equity cap as per the said exchange control norms.

¹¹⁰ Vide RBI notification no. A.P. (DIR Series) Circular No.25 dated 27 April 2018, ECB Liability to Equity Ratio for ECB raised under automatic route from direct foreign equity holder has been revised to 7:1.

6.9.6 Thin Capitalisation Rules and Double Tax Conventions

Considering that Double Tax Conventions, in addition to eliminate double taxation, could also be used to avoid taxes, significant modifications were made in the model tax conventions. Let us consider some of the Articles of the model conventions:-

i. Article 9 [“Associated Enterprises”]

Application of domestic tax laws is possible to fulfil the condition of arm’s length principle on related party transactions including loan.

ii. Article 10 [“Dividends”]

A clause is inserted which provides that the anti-avoidance rules of the domestic laws must be complied with, and in such cases, if the debt qualifies for a thin capitalisation adjustment, the interest may be treated as dividend and the debt as equity / capital.

iii. Article 24 [“Non-discrimination”]

The anti-avoidance rules including thin capitalisation rules must be applicable for all taxpayers situated in the Contracting State.

The above explains the application of anti-avoidance measures like thin capitalisation rules under various tax laws of domestic countries and also the model tax conventions. Similarly, one may also find similar clauses in the other model conventions like the UN MC, US MC, etc..

“Limitation of interest deduction”

Under the initiative of the G-20 countries, the OECD in its BEPS project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in Action plan 4. The OECD has recommended several measures in its final report to address this issue.

The Finance Act, 2017 has introduced Section 94B in the Act, dealing with limitation of interest deduction in certain cases. Section 94B of the Act provides that where an Indian company or a PE of a foreign company, being borrower, incurs any expenditure by way of interest or of similar nature exceeding INR one crore, it shall be limited to 30 per cent of EBITDA or interest paid or payable to associated enterprises, whichever is less. The limitation of interest deduction rule is different from thin capitalization rule as such limitation operates even in cases where the debt is at arm’s length if the interest breaches the specified limit of profits.

6.10 Transfer Pricing

6.10.1 Introduction

Transfer pricing has been defined as *“rules and methods for pricing transactions between enterprises under common ownership or control”*. For example, if a subsidiary company sells goods to a parent company, the cost of those goods is the transfer price.

In other words, transfer pricing refers to the ‘price’ at which goods and services are transferred/transacted by and between two or more associated enterprises. In the international tax scenario,

it refers to cross border transactions whereas under a domestic tax scenario, it refers to transactions within a particular tax jurisdiction.

The purpose of inserting Transfer pricing regulations in India is highlighted by the Memorandum to the Finance Bill, 2001. The relevant part is reproduced hereunder -

“The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income-tax Act. These provisions relate to computation of income from international transactions having regard to the arm’s length price, meaning of associated enterprise, meaning of international transaction, determination of arm’s length price, keeping and maintaining of information and documents by persons entering into international transactions, furnishing of a report from an accountant by persons entering into such transactions and definitions of certain expressions occurring in the said sections”.

A series of amendments have been carried out after the introduction of Transfer pricing regulations in order to curb the tax-avoidance measures adopted. Transactions between related parties are generally looked at with an arched eyebrow and it is becoming increasingly important for the entities of a group to comply with various documentation requirements.

6.10.2 Transactions covered

Transactions which would have a bearing on the profits, income, loss, asset, liability, etc. are covered under transfer pricing regulations. Some examples of transactions covered are as follows:-

- (i) Transfer of tangible property.
- (ii) Transfer of intangible property.
- (iii) Provision of service.
- (iv) Finance facility provided.
- (v) Cost sharing arrangements.
- (vi) Advertisement, marketing and promotion expenses incurred by an enterprise on behalf of the associated enterprise.
- (vii) Business restructuring or reorganization.
- (viii) Transaction of goods.

6.10.3 What is “Arm’s length price principle?”

The concept of “arm’s length price” refers to a price at which a transaction should have been undertaken between the two unrelated independent enterprises. In such unrelated independent transactions, the motive of both enterprises is to gain maximum benefit which will enable their business to have higher profitability. Such transactions are carried out for commercial considerations.

In related party transactions, the entire group, as a whole, has the ability to shift the profits from a high tax jurisdiction to a low tax jurisdiction in order to reduce the overall tax liability of the entire group. In related party transactions, there are very high chances for an organisation to carry on a transaction at a price which would never have been carried out by an unrelated enterprise.

The arm’s length price gives importance to the concepts of commerciality. Since it is not difficult to ascertain the motive of unrelated parties in an economic transaction, there is not much of documentation that is asked for by the revenue officials.

However, as a matter of fact, in related party transaction requiring arm’s length benchmarking, an in-depth analyses of the functions performed, risks assumed, assets employed [hereinafter referred to as ‘FAR Analysis’] by the enterprise to carry on its business as a whole is a critical factor to determine the arm’s length price of the transaction.

6.10.4 Computation of Arm’s length price using transfer pricing methods

There are various methods prescribed under the transfer pricing regulations to benchmark the economic transactions carried out between two or more related parties which are covered under Transfer pricing regulations. There may be multiple methods used to benchmark the arm’s length price. However, the following five methods are found in the transfer pricing law of almost every country which has a full-fledged comprehensive transfer pricing regime in place:-

(i) Comparable uncontrolled price (CUP) method

For understanding the basic application of the CUP method, let us consider an illustration.

- (a) A. Ltd (parent co) – a company incorporated in Mauritius has set up a wholly owned subsidiary B Ltd in India.
- (b) The multi-national group as a whole is engaged in manufacture of pharmaceutical product (hereinafter referred to as ‘drug’) of a specialised nature.
- (c) B Ltd manufactures the drug from its factories in India and exports it to parent company in Mauritius at say USD 1000/-.
- (d) Another independent unrelated party C Ltd incorporated in Mauritius purchases the product on the terms and conditions exactly similar to that of purchase of A Ltd at price of USD 950/-.
- (e) On comparison of the two transactions, it is clear that price charged by B Ltd to parent company is at a price higher than the price charged to unrelated independent party and

therefore, the transaction would not be disturbed by the tax officials in India.

- (f) If the price charged to unrelated company was USD 1050/- then, an upward transfer pricing adjustment would be required to be made by the tax officials in India.
- (g) Robust and contemporaneous documentation would be of paramount importance to justify the economic parameters considered by B Ltd at the time of carrying on the said two transactions.
- (h) The transaction with C Ltd in this case also requires some level of documentation because it is serving as a basis to benchmark the economic transaction between related parties.
- (i) A reliable comparison is therefore, absolutely necessary in such cases. However, one needs to be careful while using a CUP method that the terms and conditions of the related and unrelated transaction must be similar or substantially similar and the taxpayer must be in a position to make suitable and reliable transfer pricing adjustments, if required, based on its FAR analysis.

(ii) Resale price method (RPM)

Under this method, the normal gross profit margin accrued in the business from transacting with independent unrelated parties is compared with the gross profit margin earned in the transaction which is carried on with the related parties. As seen above in the CUP method, in the RPM as well, the nature of the transaction must be similar or substantially similar in order to have a reliable benchmark for the same. The reliability of data available and the level of information available / documentation maintained play a major role in benchmarking the related party transactions.

(iii) Cost plus method CPM)

In business activities, we have two sides viz. the receipts / turnover / sales and the other side which is known as purchases / expenses. The above two irrespective of its volume may also be indirect in nature and may play a major role in substantial profits or business activities of the organisation. It is a well-known fact that in transfer pricing and benchmarking of transactions between related parties, it is the commercial wisdom involved in pricing the related party transaction which is under scrutiny. However, it does not mean that the transfer pricing officer is supposed to sit on the chair of the business manager and judge whether there was any need of the transaction or not. The job of the transfer pricing authority is to arrive at an arm's length price of the transaction. The arm's length price must be arrived at by applying the provisions of the law. In this method, the mark up accrued to the business on costs (direct and / or indirect) from an uncontrolled transaction is compared with the mark up accrued in a related party transaction. It needs to be noted that FAR analysis is very essential and it must be carried out by the taxpayer. If there is any difference in the functions performed, assets employed or the risks assumed in the transactions selected for comparison, suitable adjustment must be made, and the transfer price must be benchmarked accordingly.

(The above three methods are direct methods which will directly benchmark the

transaction itself whereas under the remaining methods viz. Profit split and Transactional net margin method, the profitability of the entity as a whole is compared with appropriate comparable which performs similar functions, employs similar assets and assumes more or less similar risks)

(iv) Profit split method (PSM)

PSM is normally used in situations involving transfer of unique intangibles or in multiple international transactions, which are closely interrelated such that they cannot be evaluated separately. PSM may be applicable when the various entities involved in an inter-company transaction comprise one highly integrated operation, sharing more or less proportionately in the risks associated with the design, production and sale of applicable product.

To understand the applicability of the PSM method, let us consider the following Illustration –

- A. Inc., a company incorporated in USA is engaged in business of manufacturing of mobile phones.
- It has set up a WOS Company in China which is carrying out manufacturing of the mobile handsets.
- Further, A. Inc. has set up a company in Singapore which is engaged in marketing its products in the Asian region.
- A (India) Ltd, another WOS of A. Inc purchases such handsets from the Singapore based company for the purpose of sale.

Transfer pricing issue under consideration

This entire structure of A. Inc. triggers transfer pricing provisions of multiple countries. In such circumstances, based upon the FAR analysis of the group companies, profit attribution would be a big challenge.

(v) Transactional net margin method (TNMM)

This method, unlike other methods can be used flexibly and therefore, it is one of the most widely used and accepted methods. Under this method, the entity's suitable Profit level indicator (PLI) is compared with the PLI of its comparables. Comparable entities are those entities whose FAR analysis suggests that the functions performed, assets employed, and risks assumed are more or less similar in an uncontrolled situation. PLI may be post tax operating profits, net profits after tax, profit before depreciation interest and extra ordinary items, etc. depending upon the nature of business and class of the transaction. It needs to be noted that the process of selecting comparables must be in such a way that the entities selected have limited or no related party transactions. Even if there are related party transactions, the percentage of such transactions must be within tolerable limits.

For example

A. Ltd (an Indian resident company) has carried on certain related party sale transactions with its wholly owned subsidiaries outside India. The PLI selected for benchmarking purpose is Net

operating profit before tax (OPBT/ Sales). The ratio of OPBT of A Ltd is 5.22% and the average of the comparables is 4.07%. Thus, it appears that profitability of A Ltd is not adversely affected by transacting with its related parties and the above benchmarking of the economic transaction where TNMM seems to be the most appropriate method may be accepted and the transaction may be considered to be at arm's length.

To address the limitations posed by the aforesaid five methods, CBDT introduced 'Other Method' to determine the arm's length price for the intercompany transactions. The same is described herein below:

(vi) Other method

The 'Other Method' shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

Under the other method, the standards of comparability are flexible as compared to CUP method. Further, the other method gives consideration to the price that would have been charged or paid for same or similar transaction under similar circumstances. The other method does not necessitate an actual transaction but it recognizes an analysis which demonstrates independent behaviour i.e. which would be agreed between two independent enterprises. Thus, the other method gives credence to the concept of hypothetical arm's length test.

An Indian Company (I Co) buys back its equity shares issued to its foreign AE (AE Co). I Co obtains a valuation report from an external firm identifying the fair market value of these shares. I Co purchases the shares at the value determined in the valuation report. This value denotes a price that would have been charged if a third party would have bought the same shares. Hence, I Co could use Rule 10AB and rely upon the valuation report to demonstrate this transaction to be arm's length.

6.10.5 Transfer pricing and domestic transfer pricing provisions

Transfer pricing majorly targets the cross border economic transactions since the underlying purport of such transaction may be to shift the profits outside the scope of the high taxed jurisdiction. However, there are several situations wherein, a particular region within a country would be a tax haven for factors other than taxes (example:- In India, certain areas like the SEZ units enjoy tax holiday period where the specified profits of certain eligible undertakings are taxed at concessional rates or not taxed at all). In such cases, there are likely chances that a group may set up an eligible unit in the low tax areas of an otherwise taxable country. The domestic transaction of one company of a group may be carried on with another company of the same group wherein, the profits in the low tax areas (example – SEZ units) will be parked and low or no profits will be offered for taxation by the entity / company. By doing this, entities outside the designated tax-free areas can claim expenses as a deductible item from computing income. To counter such policies, various countries have extended their transfer pricing

legislation even to its domestic transactions. One such example is India.

6.10.6 Mitigating Transfer pricing Disputes

It is rightly said that “Transfer pricing is an art and not an exact science”. Accordingly, there are possibilities that views of the transfer pricing officers and taxpayers may differ. The differing views may lead to huge high pitched tax demands and long drawn out litigation. Such issues are not favourable to the business environment of a Country. In order to settle the issues and minimise the litigations that may be pending or that may arise, various procedures like “Safe Harbor Rules” or “Advance Pricing Agreements” or a combination of both may be used for safeguarding tax base of the country. At the same time, it will save the time and the cost of long drawn-out litigations.

- **Safe Harbor rules**

OECD has defined safe harbor under transfer pricing regime as “*a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country’s general transfer pricing rules*”.

In India, FA 2009 had introduced provisions under the Income-tax Act, 1961 which enabled CBDT¹¹¹, to enact the safe harbor rules. Under the Safe Harbor provisions, there are certain specified transactions under which, subject to fulfillment of the conditions of provisions under the Income-tax Rules, 1962 (Safe Harbor Rules), the transfer price declared by the taxpayer shall be regarded to be at arm’s length.

- **Advance Pricing Agreements (APAs)**

The APA procedure is similar to the Mutual Agreement procedure (MAP) provided under the DTAA. However, APA is restricted to settle the transfer pricing issues only. Under the APA procedure, the taxpayer before transacting with the related party may negotiate with the competent revenue authorities and determine the arm’s length price as per the transfer pricing methods or any other method which may be most suitable having regard to the nature and class of transaction, business dynamics involved, functions performed by contracting parties, assets employed and risks assumed. In March 2015, India in order to minimise the pending transfer pricing litigations has provided the rollback provisions as well which operates retrospectively for a period of four years. APA application for future period of five years and rollback for prior four years, thus, effectively resolves transfer pricing disputes pertaining to international transactions for a comprehensive period of nine years. As on 4th September 2019, CBDT has entered into 297 APAs including 32 Bilateral APAs¹¹². The CBDT signed 62 APAs in FY 2021-22.

¹¹¹ Central Board of Direct Taxes – Ministry of Finance

¹¹² CBDT Press Release dated 4th September 2019

6.11 Action Plans on Base Erosion and Profit Shifting (BEPS) by OECD and G20 Nations as A Measure to Safeguard Tax Base – An Overview

6.11.1 Background on BEPS

Base erosion and profit shifting (BEPS) is a global problem which requires global solution. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises (MNEs).

In an increasingly interconnected world, national tax laws have not always kept pace with tax planning by global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps that can be exploited to generate double non-taxation. This undermines the fairness and integrity of tax systems.

This increased attention and the inherent challenge of dealing comprehensively with such a complex subject has encouraged a perception that the domestic and international rules on the taxation of cross-border profits are now broken and that taxes are only paid by the naive. Multinational enterprises (MNEs) are being accused of dodging taxes worldwide and, in particular in developing countries, where tax revenues are critical to foster long term development.

Business leaders often argue that they have a responsibility towards their shareholders to legally reduce the taxes their companies pay. Some of them might consider most of the accusations unjustified, in some cases deeming governments responsible for incoherent tax policies and for designing tax systems that provide incentives for Base Erosion and Profit Shifting (BEPS). They also point out that MNEs are still sometimes faced with double taxation on their profits from cross-border activities, with mutual agreement procedures often unable to resolve disputes between governments in a timely manner, if at all.

The debate over BEPS has become politically significant and has become an issue on the agenda of several OECD and non-OECD countries. The G20 leaders meeting in Mexico on 18-19 June 2012 explicitly referred to “the need to prevent base erosion and profit shifting” in their final Declaration. This message was reiterated at the G20 finance ministers meeting of 5-6 November 2012, in the final communiqué.

The European Commission presented an Action Plan on 17-06-2015 to fundamentally reform corporate taxation in the EU. The Action Plan sets out a series of initiatives to tackle tax avoidance, secure sustainable revenues and strengthen the Single Market for businesses. The measures to be developed complement the work carried out in the OECD/G20 BEPS Project, whose outputs were released by way of 15 Action Plans in October 2015.

6.11.2 Legality and issues relating to BEPS

Corporate tax is levied at a domestic level. When MNEs undertake activities cross border, the interaction of domestic tax systems means that an item of income can be taxed by more than one jurisdiction, thus resulting in double taxation. The interaction can also leave gaps, which result in income not being taxed anywhere. BEPS strategies take advantage of these gaps between tax systems in order to achieve double non-taxation or very low taxation.

Although some schemes used are illegal, most are not. Largely they just take advantage of current rules that are still grounded in a bricks and mortar economic environment rather than today's environment of global players which is characterised by the increasing importance of digital economy, e-commerce, intangibles and risk management.

A question arises for consideration: if the BEPS strategies/schemes are considered to be legal, then why should anyone worry about BEPS. There are three important factors in this regard. First, because it distorts competition: businesses that operate cross-border may profit from BEPS opportunities, giving them a competitive advantage over enterprises that operate at the domestic level. Second, it may lead to inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax returns. Finally, it is an issue of fairness: when taxpayers (including ordinary individuals) see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers.

6.11.3 Importance of BEPS Project now and OECD's role in addressing BEPS

The OECD has been providing solutions to tackle aggressive tax planning over the years. The debate and concern over BEPS has now reached the highest political levels in many OECD and non-OECD countries. The OECD does not see BEPS as a problem created by one or more specific companies. Apart from some cases of very bad and easily noticed abuses, the issue lies with the tax rules themselves. Business cannot be faulted for making use of the rules that governments have put in place. It is therefore governments' responsibility to revise the rules or introduce new rules.

Many BEPS strategies take advantage of the interaction between the tax rules of different countries, which means that unilateral action by individual countries will not fully address the problem. In addition, unilateral and uncoordinated actions by governments responding in isolation could result in double – and possibly multiple – taxation for business. This would have a negative impact on flow of capital and technology, investment, growth and employment globally. There is therefore a need to provide an internationally coordinated approach which will facilitate and reinforce domestic actions to protect tax bases and provide comprehensive international solutions to respond to the issue. The BEPS Action Plan provides a consensus-based plan to address these issues and is part of the OECD's ongoing efforts to ensure that the global tax architecture is equitable and fair.

6.11.4 BEPS Action Plans

The BEPS Project sets forth 15 actions to address BEPS in a comprehensive and coordinated

way. These actions will result in fundamental changes to the international tax standards and are based on three core principles: coherence, substance, and transparency. The Action Plan also calls for further work to address the challenges posed by the digital economy. Looking toward innovative approaches to deliver change quickly, the Action Plan calls for a multilateral instrument that countries can use to implement the measures developed in the course of the work. While the OECD steps up its efforts to address double non-taxation, it will also continue work to eliminate double taxation, through increased efficiency of mutual agreement procedures and arbitration provisions.

In July 2013, G20 called on the OECD to commence work on 15 actions designed to ensure the coherence of corporate income taxation at the international level. The OECD, on 5 October 2015 issued the final reports in connection with all the 15 Action Plans to address BEPS, together with a plan for follow-up work and a timetable for implementation.

6.11.5 Actions Plans being carried out in the context of BEPS

Domestic tax systems are coherent when tax deductible payments by one person results in income inclusions by the recipient. We need international coherence in corporate income taxation to complement the standards that prevent double taxation with a new set of standards designed to avoid double non-taxation. Four actions in the BEPS Action Plan (Actions 2, 3, 4, and 5) focus on establishing this coherence.

Current rules work well in many cases but must be modified to prevent instances of BEPS. The involvement of third countries in the bilateral framework established by treaty partners puts a strain on the existing rules, in particular when done via shell companies that have little or no economic substance: e.g., office space, tangible assets, business operations and employees. In the area of transfer pricing, rather than replacing the current system, the best course is to fix the flaws in it, in particular with respect to issues related to over-capitalisation, risk and intangible assets. Nevertheless, special rules, either within or beyond the arm's length principle, may be required with respect to these flaws. Five actions in the BEPS Action Plan focus on aligning taxing rights with substance (Actions 6, 7, 8, 9, and 10).

Because preventing BEPS requires greater transparency at many levels, the Action Plan calls for: improved data collection and analysis regarding the impact of BEPS; taxpayers' disclosure about their tax planning strategies; and less burdensome and more targeted transfer pricing documentation. Four actions in the BEPS Action Plan focus on improving transparency (actions 11, 12, 13, and 14).

The brief description, timeline and present status of the Action plans are given in para 2 below.

6.11.6 Implementation of the BEPS Actions

The BEPS Action Plan calls for the development of tools that countries can use to shape fair, effective and efficient tax systems. Because BEPS strategies often rely on the interaction of countries' different systems, these tools will have to address the gaps and frictions that arise from the interaction of these systems. Some actions, for example, work on the OECD Transfer Pricing Guidelines and the Commentary to the OECD MC, will result in changes that are directly

effective. Others will be implemented by countries through their domestic law, bilateral treaties, or a multilateral instrument.

6.11.7 Role of the G20 in BEPS Project

Since its launch by the OECD, the work on BEPS received strong and consistent support by the G20 and it is a key item on the Finance Ministers' and Leaders' agendas. Furthermore, all G20 countries have participated as equal partners in the development of the work. Their continued participation and endorsement at the highest levels of government have been critical to guarantee a level playing field and prevent inconsistent standards.

The delivery of the 2014 BEPS outputs is concrete evidence of how OECD and G20 members working together can achieve consensus on important tax reforms with a worldwide impact. Non-OECD G20 countries are Associates in the BEPS Project and participate on an equal footing in the decision-making process, at the level of both the OECD Committee on Fiscal Affairs and of its subsidiary bodies carrying out the technical work. Since its inception in 2016, the OECD/G20 Inclusive Framework on BEPS is now comprised of 141 countries and jurisdictions. In addition, other countries and stakeholders have engaged in regular and fruitful dialogues throughout this process.

6.11.8 BEPS Action Plan and Tax Competition

Taxation is at the core of countries' sovereignty, and each country is free to set up its corporate tax system as it chooses, including by charging the rate it chooses. The work is not aimed at restricting the sovereignty of countries over their own taxes; instead, it is aimed at restoring and strengthening sovereign taxing rights by ensuring that countries can protect their tax bases. It does so by addressing regimes that apply to mobile activities and that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services.

6.11.9 Risk of not addressing harmful tax practices

The dangers of not addressing harmful tax practices can be felt both by governments and business. Firstly, harmful tax competition can introduce distortions and an unequal level playing field between businesses operating at domestic level and those that operate globally and have access to preferential tax regimes. Secondly, countries have long recognised that a "race to the bottom" would ultimately drive applicable tax rates on certain sources of income to zero for all countries, whether or not this is the tax policy a country wishes to pursue.

6.11.10 BEPS Action Plan & "tax havens"

The BEPS Action Plan aims to end the use of shell companies used to stash profits offshore or unduly claim tax treaty protection and neutralise all schemes that artificially shift profits offshore. Though the BEPS Action Plan is not about dictating whether countries should have a specific corporate income tax rate, it will have an impact on regimes that seek to attract foreign investors without requiring any economic substance.

6.11.11 Is BEPS effectively a tax increase on multinationals?

The BEPS project is not about increasing corporate taxes. Non- or low-taxation is not itself the concern, but it becomes so when it is achieved through practices that artificially separate taxable income from the activities that generate it. These strategies may increase tax disputes as countries fight against tax strategies that defy common sense. Implementation of the recommendations coming out of the BEPS project will reduce those disputes, giving business greater certainty, and reinforcing the fairness and consistency of international tax system.

6.11.12 Involvement of businesses and civil society in BEPS Project

During the course of the work so far, stakeholders have been consulted at length. Discussion drafts released during the course of the work so far have generated more than 3,500 pages of comments and have attracted a large number of participants at various public consultations. The OECD's public webcasts of these consultations and updates on the project have attracted more than 10,000 viewers. This transparent and inclusive consultation process will continue throughout the course of the work.

6.11.13 BEPS Action Plan and offshore tax evasion

The work on BEPS focuses largely on legal tax planning techniques rather than offshore tax evasion, which is illegal. However, other work being carried out by the OECD and the OECD Global Forum on Transparency and the Exchange of Information is focused on combating offshore tax evasion. More information about this work can be found online at www.oecd.org/tax/exchange-of-taxinformation.

6.11.14 Brief description, timeline and present status of the BEPS Action Plans¹¹³

Action 1 – Addressing the tax challenges of the digital economy

(a) **Objective:** Report identifying issues raised by the digital economy and possible actions to address them.

(b) **Present Status:** Final Report Issued in October 2015. To carry out the work given under this Action Plan, a Task Force on Digital Economy ('TFDE') was established which was mandated with a task to present an interim report by the end of 2018 and come up with the final recommendations by the end of 2020.

Key milestones accomplished so far are listed below:

Date	Milestone
March 2018	Interim report titled "Tax Challenges Arising from Digitalisation - Interim Report 2018 released
January 2019	Policy note on addressing the Tax Challenges of the Digitalisation of the Economy

¹¹³ <http://www.oecd.org/ctp/beps-actions.htm>

Date	Milestone
February-March 2019	Public consultation document on the possible solutions
May 2019	OECD took a major step forward with the agreement on the Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy which focuses on 2 pillars
November 2019	Public Consultation for a suggested "Unified Approach" under Pillar One
December 2019	Public Consultation for a Global Anti_Base Erosion Proposal (GloBE) under Pillar Two
January 2020	Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy
October 2020	Delivery of the Reports on the Blueprints of Pillar One and Pillar Two
October-December 2020:	Public Consultation - Report on Pillar One and Pillar Two blueprints
January 2021	Public Consultation Meetings - Report on Pillar One and Pillar Two blueprints
July 2021	131 countries and jurisdictions joined a new two-pillar plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate. The global minimum corporate income tax under Pillar Two - with a minimum rate of at least 15% - is estimated to generate around USD 150 billion in additional global tax revenues annually. ¹¹⁴
December 2021	Release of Global Anti-Base Erosion Model (GloBE) Rules – Pillar Two
March 2022	Commentary to the Global Anti-Base Erosion Model (GloBE) Rules – Pillar Two
July 2022	Public Consultation on the progress report on Amount A – Pillar One
December 2022	Public Consultation on the progress report on Amount B – Pillar One
December 2022	Release of consultation document on the withdrawal of digital service taxes and other relevant similar measures under Pillar One and an implementation package for Pillar Two
July 2023	Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy
July 2023	Release of GloBE Information Return to facilitate compliance with and administration of the GloBE Rules

¹¹⁴ <https://www.oecd.org/tax/beps/beps-actions/action1/>

Date	Milestone
October 2023	Release of model treaty provision to give effect to the Subject to Tax Rule (STTR), together with an accompanying commentary explaining the purpose and operation of the STTR.
October 2023	Release of Minimum Tax Implementation Handbook
October 2023	Release of Multilateral Convention to implement Amount A of Pillar One

(c) Description of tasks and issues:

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.

Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location relevant data through the use of digital products and services, the characterization of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.

The Interim Report released on 16th March 2018 sets out the BEPS inclusive framework's agreed direction of work on digitalization and the international tax rules through 2020. It describes how digitalization is also affecting other areas of the tax system, providing tax authorities with new tools that are translating into improvements in taxpayer services, improving the efficiency of tax collection and detecting tax evasion.

Policy note and public consultation document contains concrete proposals made by members framed within two complementary pillars, as under:

Pillar 1 - Re-allocation of profit and revised nexus rules: This pillar will explore potential solutions for determining where tax should be paid and on what basis i.e. nexus, as well as what portion of profits could or should be taxed in the jurisdictions where clients or users are located i.e profit allocation.

Pillar 2 - Global anti-base erosion mechanism: This pillar will explore the design of a system to ensure that multinational enterprises – in the digital economy and beyond – pay a minimum level of tax. This pillar is intended to address remaining issues identified by the OECD/G20 BEPS initiative by providing countries with new tools to protect their tax base from profit shifting to jurisdictions which tax these profits at below the minimum rate.

Action 2 – Neutralising the effects of hybrid mismatch arrangements

(a) Objective: Changes to the Model Tax Convention Recommendations regarding the design of domestic rules.

(b) Present Status: Final Report issued in October 2015. A discussion draft on branch mismatch structures was released on 22 August 2016 by OECD. The final report of the same was released by OECD on 27 July 2017 titled “*Neutralising the Effects of Branch Mismatch Arrangements*”.

(c) Description of tasks and issues:

Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.

These include: (i) changes to the OECD MC to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payer; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on coordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD MC. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.

The final report on branch mismatch structure released on 27 July 2017 sets out recommendations for branch mismatch rules in order to bring the treatment of these structures in line with the treatment of hybrid mismatch as per Action Plan 2.

Action 3 –Designing effective Controlled Foreign Company (CFC) Rules

(a) Objective: Recommendations regarding the design of domestic rules.

(b) Present Status: Final Report issued in October 2015. Presently, almost 50 OECD/G20 Inclusive Framework countries have now enacted CFC rules, with EU Member States all having CFC rules in effect since the beginning of 2019 following the adoption of Council Directive (EU) 2016/1164, with a number of additional countries considering the adoption of CFC rules for the first time¹¹⁵.

(c) Description of tasks and issues:

Develop recommendations regarding the design of controlled foreign company rules. The recommendations suggested by this Action Plan are designed to ensure that jurisdictions that choose to implement them, have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries. This work will be coordinated with other work as necessary.

¹¹⁵<https://www.oecd.org/tax/beps/beps-actions/action3/>

Action 4 – Limiting base erosion involving interest deductions and other financial payments

(a) **Objective:** (i) Recommendations regarding the design of domestic rules.

(ii) Changes to the Transfer Pricing Guidelines

(b) **Present Status:** Final Report issued in October 2015. On 22 December 2016, the OECD released an updated version of the BEPS Action 4 report which includes further guidance on two areas: the design and operation of the group ratio rule, and approaches to deal with risks posed by the banking and the insurance sectors. In April 2018 the OECD released a consultation draft on limiting the impact of excessive interest deductions on mining revenues.

(c) **Description of tasks and issues:**

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be coordinated with the work on hybrids and CFC rules.

Action 5 - Countering harmful tax practices more effectively, taking into account transparency and substance

(a) **Objective:** The OECD Forum on Harmful Tax Practices (FHTP) has been conducting reviews of preferential regimes since its creation in 1998 in order to determine if the regimes could be harmful to the tax base of other jurisdictions. The current work of the Forum on Harmful Tax Practices (FHTP) comprises three key areas.

Firstly, the assessment of preferential tax regimes to identify features of such regimes that can facilitate base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions.

Secondly, the peer review and monitoring of the Action 5 transparency framework through the compulsory spontaneous exchange of relevant information on taxpayer-specific rulings which, in the absence of such information exchange, could give rise to BEPS concerns.

Thirdly, the review of substantial activities requirements in no or only nominal tax jurisdictions to ensure a level playing field.

Present Status: Final Report issued in October 2015. The OECD on 1 February 2017 released key documents which will form the basis on which the peer review and the monitoring processes will be undertaken. On 16 October 2017, the OECD released a report titled “*Harmful Tax*

Practices - 2017 Progress Report on Preferential Regimes”, approved by the inclusive framework on BEPS. This document combines all aspects of the work of the Forum for Harmful Tax Practices (‘FTHP’) on preferential regimes since the release of this Action Plan. OECD releases the peer review reports on exchange of information on tax rulings titled “Harmful Tax Practices-Peer Review Reports on the Exchange of Information on Tax Rulings” periodically and latest report was published on 13 December 2023.

(b) Description of tasks and issues:

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.

Action 6 – Preventing the granting of treaty benefits in inappropriate circumstances

(a) Objective: (i) Changes to the Model Tax Convention; and (ii) Recommendations regarding the design of domestic rules.

(b) Present Status: Final Report issued in October 2015. The OECD released a discussion draft on treaty residence of pension funds in February 2016. Further, paragraph 14 of the final report on this Action Plan had indicated that the OECD will continue to examine issues related to the treaty entitlement of non-CIV. In March 2016 the OECD has released a consultation document on treaty entitlement of non-CIV funds. On 29 May 2017, the OECD released the key document which will form the basis of the peer review of the Action 6 minimum standard on preventing the granting of treaty benefits in inappropriate circumstances.

(c) Description of tasks and issues:

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids.

Action 7 – Prevent the artificial avoidance of PE status

(a) Objective: Changes to the Model Tax Convention.

(b) Present Status: Final Report issued in October 2015. The OECD in July, 2016, released a discussion draft in relation to additional guidance on the attribution of profits to a PE. Comments on which were received in September 2016. Further one more discussion draft on the same was released by OECD in June 2017 and comments on which were received in October 2017. Considering the discussion drafts and the comments received thereon, the OECD on 22 March 2018 released a report on “*Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7*” which contains additional guidance on

attribution of profits to PE resulting from the changes in this Action Plan and to Article 5 of the OECD MC.

The changes to the permanent establishment definitions were integrated in the 2017 OECD Model Tax Convention and in Part IV of the Multilateral Instrument (Articles 12 to 15), which was signed by nearly 90 jurisdictions and about half of the MLI Signatories have so far adopted the MLI articles that implement the permanent establishment changes.

(c) Description of tasks and issues:

Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions.

Work on these issues will also address related profit attribution issues.

Action 8 – Assure that transfer pricing outcomes are in line with value creation: intangibles

(a) Objective: Changes to the Transfer Pricing Guidelines and possibly to the Model Tax Convention.

(b) Present Status: Final report released in October 2015. However, follow-up work on the transactional profit split method, will be finalised in the first half of 2017. On 10 July 2017 the OECD released the *“Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”* which incorporates the clarifications and revisions agreed in BEPS Actions 8-10 and Action 13 (Country by Country Reporting).

(c) Description of tasks and issues:

Develop rules to prevent BEPS by moving intangibles among group members. Phase:

- (i) adopting a broad and clearly delineated definition of intangibles;
- (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
- (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and
- (iv) updating the guidance on cost contribution arrangements.

Action 9 – Assure that transfer pricing outcomes are in line with value creation: risks and capital

(a) Objective: Changes to the Transfer Pricing Guideline and possibly to the Model Tax Convention.

(b) Present Status: Final report released in October 2015. On 10 July 2017 the OECD released the *“Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”* which incorporates the clarifications and revisions agreed in BEPS Actions 8-10 and Action 13

(Country by Country Reporting).

(c) Description of tasks and issues: Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules require alignment of returns with value creation.

Action 10 – Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions

(a) Objective: Changes to the Transfer Pricing Guideline and possibly to the Model Tax Convention.

(b) Present Status: Final report released in October 2015. Significant progress has been made on the projects mandated by the 2015 Final Report on Actions 8-10, including but not limited to the following achievements:

- Revised guidance on transactional profit split method (Action 10) was published in June 2018 and incorporated into the latest edition of the OECD Transfer Pricing Guidelines.
- Additional guidance addressed to tax administrations on the application of the hard-to-value intangibles (HTVI) approach (Action 8) was finalised in June 2018 and incorporated in the latest edition of the OECD Transfer Pricing Guidelines.
- New transfer pricing guidance on financial transactions (Actions 4 and 8-10) was published in February 2020 and incorporated in the latest edition of the OECD Transfer Pricing Guidelines.

(c) Description of tasks and issues:

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to:

- (i) clarify the circumstances in which transactions can be re-characterised;
- (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and
- (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

Action 11 – Measuring and monitoring BEPS

(a) Objective: Recommendations regarding data to be collected and methodologies to analyse them.

(b) Present Status: Final report was issued in October 2015. As part of the ongoing work under Action 11, the Inclusive Framework is developing new and enhanced datasets and analytical tools that can assist in measuring and monitoring the fiscal and economic impacts of tax avoidance and the effects of the implementation of the BEPS measures.

In particular, the Inclusive Framework is working to improve the quality and expand the range of information available to analyse BEPS. The Corporate Tax Statistics database, which was first launched in January 2019, has assembled a variety of data relevant to the analysis of BEPS and corporate taxation. In developing the database, the OECD worked closely with members of the Inclusive Framework and other jurisdictions willing to participate, and as a result, it includes information for all members of the Inclusive Framework.

The second edition of Corporate Tax Statistics (OECD 2020) included the first aggregated and anonymised statistics prepared from data received on Action 13 Country-by-Country Reports (CbCRs) in 2020. Subsequent editions expanded these CbCR statistics, which now cover more than 50 jurisdictions and 95% of all CbCRs filed (almost 7500 CbCRs). New data series have also been introduced, including indicators of the impact of expenditure-based tax incentives for R&D, data on Interest Limitation Rules (ILR) and Controlled Foreign Company (CFC) rules, and data on Withholding Tax rates.

(c) Description of tasks and issues:

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it.

The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.

Action 12 – Mandatory Disclosure Rules

(a) Objective: Recommendations regarding the design of domestic rules.

(b) Present Status: Final report issued in October 2015. The OECD released a report titled *“Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures”* in March 2018. The structure of these rules is based on the best practice recommendations of this Action Plan specifically targeting these types of arrangements and structures. Part I gives an overview of the model rules; Part II sets out the text of the rules; and Part III provides a commentary on those rules.

(c) Description of tasks and issues:

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design

allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of “tax benefit” in order to capture such transactions. The work will be coordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.

Action 13 – Transfer pricing documentation and country-by-country (CbC) reporting

(a) Objective: Changes to Transfer Pricing Guidelines and recommendations regarding the design of domestic rules.

(b) Present Status: Final report released in October 2015. 58 jurisdictions required or permitted the filing of CbC reports for 2016 and more than 110 jurisdictions have law in place introducing a CbC reporting obligation. In addition, as of October 2022, over 3300 relationships are in place for the exchange of CbC reports between jurisdictions. This means that substantially every MNE with consolidated group revenue of at least EUR 750 million is already required to file a CbC report, and the gaps that do remain are closing.

(c) Description of tasks and issues:

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules developed include a requirement that MNE’s provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.

To this end, a three-tiered standardised approach to transfer pricing documentation has been developed as under:

Master file - Providing tax administrations with high-level information regarding Multinational Enterprises’ (MNE’s) global business operations and transfer pricing policies.

Local file - Detailed transactional transfer pricing documentation to be provided in a “local file” specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions.

CbC Report - Large MNEs are required to file a CbC Report that will provide annually and for each tax jurisdiction information on global allocation of income, taxes paid/accrued, the stated capital, accumulated earnings, number of employees and tangible assets. It also requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

Action 14 – Make Dispute resolution mechanisms more effective

(a) Objective: Changes to the Model Tax Convention

(b) Present Status: Final report issued in October 2015. On 20 October 2016, the OECD

released the key documents that will form the basis of the Mutual Agreement Procedure (MAP) peer review and monitoring process under Action 14 of the BEPS Action Plan. In accordance with the Assessment Methodology, the reviews is conducted in batches, with the first batch having commenced in December 2016. The reports for six jurisdictions that were peer reviewed in first batch have been released and approved by the FTA MAP Forum.

(c) Description of tasks and issues:

Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.

Action 15 – Developing a Multilateral Instrument to modify bilateral tax treaties

(a) Objective: (i) Report identifying relevant public international law and tax issues; and (ii) Develop a multilateral instrument.

(b) Present Status: (i) Final Report issued in October 2015. In November 2016, the OECD released the Multilateral Instrument along with the Explanatory Statement. The Multilateral Instrument opened up for signature on 31 December 2016. The Instrument transposed results from the BEPS project into more than 2000 tax treaties worldwide. A signing ceremony was held in June 2017 in Paris. On 7 June 2017, 68 countries signed the “*Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting*” in Paris. As on 1 December 2023, 102 countries had signed the MLI and 85 countries had deposited the instrument of ratification with OECD.

(c) Description of tasks and issues:

Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.

The MLI may be considered as one of the key outcomes of the BEPS project which would ensure implementation of the recommendations of the Action Plans.

Principles of International Tax Law

1. International Tax Law

1.1 Introduction

Article 38(1) of the International Court of Justice¹ provides that the court shall apply the following in deciding on a particular matter –

- (a) International convention(s) (general or particular) which establishes rules expressly recognised by the contesting states;
- (b) International custom; as evidence of general practice accepted as law;
- (c) General principles recognised by civilized nations and;
- (d) Judicial decisions and teachings of highly qualified publicists of various nations, as subsidiary means for determination of rules of law.

Success of any law depends upon the manner in which it is interpreted and administered. In order to interpret the law, one needs to understand the philosophy of law. This is because it is this philosophy which has been kept in mind at the time of passing any law in a country or at the time of forming an agreement between the two countries on a particular aspect. This gives rise to the principles of public international law (example – U.N principles on business and human rights).

Tax has been a consequence of business for several hundreds of years; some of the principles would definitely have their bearing on the manner in which law is passed. International tax law has evolved so that conflict of national interests can be resolved (double taxation being the primary issue).

International tax law emanates from the following –

- (i) Multilateral international agreements (example – The Vienna Convention on Law of Treaties-VCLT, the Multilateral Instrument signed under the avoidance of Base Erosion and Profit Shifting (BEPS) initiative of the OECD²
- (ii) Double Tax Avoidance Agreement (DTAA) which may be comprehensive or otherwise. It is to be noted that along with the DTAA, it is the protocols, memorandum of understanding, and exchange of letters/Notes, etc. forming part of the DTAA which enables interpretation of a DTAA.

¹http://www.icj-cij.org/documents/?p1=4&p2=2#CHAPTER_II

²Organisation for Economic Co-operation and Development

- (iii) Customary international law and general principles of law (example - principles of law recognised by civilized nations in their national legal systems, customary law and judicial decisions and the practices of international organizations). Customary international law is the aspect of international law that derives from customs and convention. Along with general principles of law and treaties, custom is considered by the International Court of Justice, jurists, the United Nations, and its member states to be among the primary sources of international law. The vast majority of governments accept in principle the existence of customary international law, although there are many differing opinions as to what rules are contained therein.

1.2 Double Taxation and Connecting Factors

1.2.1 Connecting Factors

The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business **with that country** or **in that country**. Internationally, the term used to determine the jurisdiction for taxation is “connecting factors”. **There are two types of connecting factors, namely, “Residence” and “Source”**. It means a company can be subject to tax either on its residence link or its source link with a country. Broadly, if a company is **doing business with** another country (i.e. host/source country), then it would be subject to tax in its home country alone, **based on its residence link**. However, if a company is **doing business in** a host/source country, then, besides being taxed in the home country on the basis of its residence link, it will **also be taxed** in the host country on **the basis of its source link**. In such a situation, double taxation would arise, where same income is subject to taxation in the same period by two tax jurisdictions. This type of double taxation is known as jurisdictional double taxation.

As double taxation adversely affects after tax profits and thereby international trade, relief is provided through tax treaties [also called, Double Taxation Avoidance Agreement (DTAA), or Double Taxation Convention–DTC]. The reduction or elimination of double taxation is achieved by distributing jurisdictions to tax between host country and residence country. The relief is also provided unilaterally under domestic tax law. In India, in the absence of such an agreement, an Indian resident can invoke the provisions of section 91 of the Income-tax Act, 1961 (the Act) which provides unilateral relief in the event of double taxation.

Example: Company ICO is a resident of India. It has set up a branch in UK. Here, India would be the country of residence for ICO, whereas UK would be the country of source. UK would tax the profits earned by the branch of ICO located in UK, whereas ICO would be taxed on worldwide basis in India, including profits of its UK branch. However, ICO can claim relief in respect of taxes paid in UK while filing its tax return in India under the Indo-UK DTAA. If, instead of UK, ICO has a branch in Virgin Islands, then, it can claim unilateral relief under section 91 of the Act, in respect of taxes paid by its Virgin Islands

branch as India does not have a tax treaty with Virgin Islands.

1.3 Some other important concepts

The concept of taxation based on source or/and residence prevailing in a majority of the countries is the root cause of double taxation. Hence, there is a need to have tax treaties in force. In addition to allocating the taxing rights and elimination of double taxation, there are various other important objectives as mentioned below:

- Ensuring non-discrimination in treatment for taxation of nationals and enterprises of the treaty partner-country
- Resolution of disputes arising on account of different interpretations of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.
- Exchange of information

Further, in addition to above, there are some other principles which must be considered by countries in their tax system –

(i) Equity and fairness

Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.

(ii) Neutrality and efficiency

Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold. (i) Capital export neutrality (CEN) and (ii) Capital import neutrality (CIN). Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) Promotion of mutual economic relation, trade and investment

In some treaties, the avoidance of double taxation is not the only objective. The objectives may also be to give impetus to a country's overall economic growth and development.

2. Application of Tax Treaties

2.1 Introduction

An environment which promotes development of global trade and commerce is the sine qua non. Therefore, flexible, effective and efficient laws become an essential prerequisite. In the context of tax laws, harmful effects of double taxation are sought to be eliminated by countries through the medium of DTAA. DTAAs are entered into by two

states. In the Indian context, Article 51 of the Indian Constitution has inter-alia set out some directive principles which must be followed in the context of International agreements and relationships. It has been provided that-

"The State shall endeavour to -

- (a) *promote international peace and security;*
- (b) *maintain just and equitable relations amongst nations;*
- (c) *foster respect for international law and treaty obligations in the dealings of organised people with one another;*
- (d) *encourage settlement of international disputes by arbitration.*

(Emphasis supplied)

It is pertinent to note that entries 10 and 14 of list I of the seventh schedule confer the power on the Parliament to legislate treaties with foreign countries. Further, this power of Parliament has been delegated to the Central Government vide section 90 and 90A of the Act.

Section 90(4) of the Act, provides that the non-resident to whom the DTAA in section 90(1) applies, shall be **allowed to claim the relief** under such DTAA **if a Tax Residency Certificate (TRC)** obtained from the Government of that country or specified territory **is furnished** declaring his residence of the country outside India or the specified territory outside India, as the case may be. Further vide notification F. No. DGIT(S)-ADG(S)-3/e-Filing Notification/Forms/2023/ 13420, every non-resident is mandatorily required to e-file Form 10F³, where the desired details in the TRC are not available.

2.2 Role of Vienna Convention in application and interpretation of Tax Treaties

Tax treaty being a part of international law, its interpretation should be based on certain set of principles and rules of interpretation. The Vienna Convention on Law of Treaties, which is ratified by 116 Countries⁴ as of April, 2018 provides the basic rules of interpretation of any international agreement (including a tax treaty). Therefore, it would be important to understand some of the articles of the Vienna Convention on Law of Treaties which are useful in understanding application and interpretation of tax treaties.

2.2.1 Vienna Convention on Law of Treaties⁵

The principles are as under –

Article 26 – Pacta Sunt Servanda

Every treaty in force is binding upon the parties and must be followed by them in good

³ Form 10F is a statement verifying an individual or entity's qualification to seek tax benefit following the DTAA.

⁴Source:https://treaties.un.org/pages/ViewDetailsIII.aspx?src=TREATY&mtdsg_no=XXIII-1&chapter=23&Temp=mtdsg3&clang=_en

⁵ <https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf>

faith.

Article 27 – Internal law and observance of treaties

A party may not invoke the provisions of its internal law as justification for its failure to perform obligations under a treaty. This rule is without prejudice to article 46⁶.

Article 28 – Non retroactivity of treaties

Unless a different intention appears from the treaty or is otherwise established, treaty provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to that party.

In other words, unless otherwise provided, treaties cannot have retrospective application.

Article 29 – Territorial Scope of Treaties

Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory⁷.

Article 30 – Application of Successive Treaties relating to the same subject matter

- Subject to Article 103 of the Charter of the United Nations, the rights and obligations of States that are party to successive treaties relating to the same subject-matter shall be determined in accordance with the following paragraphs.
- When a treaty specifies that it is subject to, or that it is not to be considered as incompatible with, an earlier or later treaty, the provisions of that other treaty shall prevail.
- When all the parties to the earlier treaty are also parties to the later treaty but that the earlier treaty is not terminated or suspended in operation under article 59, the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty.
- When the parties to the later treaty do not include all the parties to the earlier one: (a) As between States parties to both treaties the same rule applies as in paragraph 3; (b) As between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and

⁶ Article 46 – Provisions of internal law regarding competence to conclude treaties

1. A State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.
2. A violation is manifest if it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith.

⁷For e.g. Income-tax Act, 1961 applies to whole of India.

obligations.

- Paragraph 4 is without prejudice to article 41, or to any question of termination or suspension of the operation of a treaty under article 60 or to any question of responsibility which may arise for a State from the conclusion or application of a treaty the provisions of which are incompatible with its obligations towards another State under another treaty.

Article 31 – General Rule of Interpretation

- A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms thereof in the context and in the light of its object and purpose.
- The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure
 - (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related thereto.
- The following shall be taken into account, together with the context in that:
 - (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) Any relevant rules of international law applicable to relation between the parties.
- A special meaning shall be given to a term if it is established that the parties so intended⁸.

Article 32 – Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:(a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.

Article 33 – Interpretation of Treaties Authenticated in two or more languages

- When a treaty has been authenticated in two or more languages, the text is equally

⁸ Article 3 of the Model tax convention (U. N and OECD model)

authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.

- A version of the treaty in a language other than the one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
- The terms of the treaty are presumed to have the same meaning in each authentic text.
- Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference in meaning which the application of articles 31 and 32 do not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

Article 34 – General Rule regarding third states

A treaty does not create either obligations or rights for a third State without its consent.

Article 42 – Validity and Continuance in force of treaties

- The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the Convention⁹.
- The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the Convention. The same rule applies to suspension of the operation of a treaty.

Article 46 – Provisions of internal law regarding competence to conclude treaties

- A State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.
- A violation is manifest if it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith.

Article 60 – Termination or Suspension of the operation of a treaty as a consequence of a breach

- A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part.
- A material breach of a multilateral treaty by one of the parties entitles:
 - (a) The other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either: (i) in the relations amongst

⁹ Present convention refers to the “Vienna Convention on Law of Treaties”

- themselves and the defaulting State, or (ii) As between all the parties;
- (b) A party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in whole or in part in the relations between itself and the defaulting State;
 - (c) Any party other than the defaulting State to invoke the breach as a ground for suspending the operation of the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every other party with respect to further performance of its obligations under the treaty.
- A material breach of a treaty, for the purposes of this article, consists in:
 - (a) A repudiation of the treaty not sanctioned by the Convention; or
 - (b) The violation of a provision essential to the accomplishment of the object or purpose of the treaty.
 - The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.
 - Paragraphs 1 to 3 do not apply to provisions relating to the protection of the human person contained in treaties of a humanitarian character, in particular to provisions prohibiting any form of reprisals against persons protected by such treaties.

Article 61 – Supervening impossibility of performance

- A party may invoke the impossibility of performing provision of a treaty as a ground for terminating or withdrawing from it if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending its operation.
- Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party thereto.

Article 62 – Fundamental change of circumstances

- A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless –
 - (a) The existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and
 - (b) The effect of the change is radically to transform the extent of obligations still

to be performed under the treaty.

- A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty –
 - (a) If the treaty establishes a boundary; or
 - (b) If the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.
- If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending its operation.

Article 63 – Severance of Diplomatic or Consular relations

The severance of diplomatic or consular relations between parties to a treaty does not affect the legal relations established between them by the treaty except in so far as the existence of diplomatic or consular relations is indispensable for the application thereof.

Article 64 – Emergence of new peremptory norm of general international law

If a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and stands terminated.

2.3 Anti–Avoidance measures

In various countries, unless the context otherwise requires, the provisions of the DTAA shall prevail over the domestic tax provisions. No two treaties between the countries are alike. DTAA signed by India with USA is different in comparison to the DTAA signed with other countries, say Netherlands. These differences induce taxpayers to resort to tax arbitrage strategies. This frustrates Government's objective and results in unintended tax benefits. Therefore, in specified circumstances, treaty benefits are denied. Some of the circumstances in the Indian context include (i) General Anti – Avoidance Rules (GAAR)¹⁰ (ii) targeted anti avoidance rules (transfer pricing), etc. (iii) Beneficial Ownership Conditions (iv) Limitation of Benefits Clause/ Articles, etc.

Recently, India has re-negotiated DTAA's with countries like Mauritius, Singapore, etc. to prevent fiscal evasion with respect to taxes on income and capital gains of the investor¹¹.

2.4 Article 4 of DTAA – Gateway to avail tax benefits

It is a well-accepted proposition in a tax treaty scenario that a person shall be entitled to

¹⁰ GAAR provisions in India are applicable from Assessment Year 2018-19

¹¹Effective from 01 April 2017

a tax treaty only if he is a resident of one of the contracting states.

Though 'Article 4' of the tax treaty deals with residential status of a person, it does not provide rules for determination of the residence. Instead, it refers to the determination in accordance with the provisions of domestic tax law of the respective contracting state. This is clear from the language which provides that "*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, place of management or any other criterion of a similar nature.....*". Therefore, the primary requirement is for a person to qualify as a resident under the law of the concerned contracting state.

Determination of residential status of a person is crucial since it is ultimately the country of residence that may have full right to tax the worldwide income of its resident. Further, in addition to taxing the global income, the country of residence would grant relief in respect of tax paid in the country of source. It is to be borne in mind that the comprehensive taxation in a contracting state that determines residence in that state does not mean that that state is required to fully tax all the income of the person concerned. Even if that state does not tax a particular item of income, so long as the taxation in that state is by reason of the connecting factors of the person, and not merely because the income is sourced in that state, that person is a treaty resident of that state.

In case of corporate entities, the Place of effective management (POEM) is an important criteria for determining the beneficiary of a tax treaty. India has notified final rules under its domestic regulations for determining residence based on POEM¹².

India – U.A.E DTAA (as revised) limits the application of treaty by providing that the treaty would be applicable to U.A.E company only if it is incorporated in U.A.E and is managed and controlled wholly in U.A.E. Only such company would be regarded as resident of U.A.E. Further the India – U.A.E DTAA provides that a person other than an individual is resident of both the States, then it should be deemed to be resident of the State in which its Place of effective management is situated.

By virtue of the Multi-Lateral Instrument (MLI) signed by the countries under the OECD - BEPS initiative, in cases of dual residence Paragraph 1 of Article 4 (which intends to give effect to the recommendations of Action 6 of the BEPS project by providing for modification of the tie-breaker test for persons other than individuals) provides that, where a person other than an individual is a resident of more than one contracting jurisdiction, the residential status of such person shall be determined mutually by the competent authorities of these contracting jurisdictions having regard to the place of effective management ('POEM'), the place where it is incorporated or constituted and other relevant factors. Article 4 further provides that in the absence of a mutual agreement between the competent authorities such person shall not be eligible to claim

¹² Circular No. 6 of 2017 dated 24 January 2017 along with clarifications vide circulars 8 of 2017 dated 23 Feb 2017 and circular 25 of 2017 dated 23/10/2017

any relief or exemption from tax under the tax treaties, except as agreed by the competent authorities.

2.5 Computation of income liable for the purpose of taxation

The provisions of tax treaty inter – alia allocates taxing rights between the treaty partners, provides relief or reduces or eliminates the harmful effects of double taxation. However, it is to be noted that except for the provisions under ‘*Article 7, Business Profits taxation*’, generally treaties do not provide rules for computation of income. It would depend upon the domestic tax law provisions. Treaties at best distribute the taxing rights between two states. It may limit the rate of tax (generally in the state of source) or provide the upper limit up to which taxes can be levied. Certain treaties do reduce the incidence of tax by providing or restricting the scope of the subject matter of taxation. For e.g., India – USA DTAA provides that Technical Fees paid would be taxable in the hands of the recipient only when the underlying technology is made available to the payer of the ‘fees’. Certain treaties restrict the scope of taxation by providing ‘Most Favoured Nation (MFN)’¹³ clause in the Protocol or Exchange of Letter to a DTAA.

2.6 Distributive Rule¹⁴

As mentioned above, tax treaties distribute or assign taxing jurisdiction for reducing or elimination double taxation. These do not impose tax. While tax treaties assign jurisdiction of tax to the State of Residence and State of Source, the domestic tax laws of the respective State determine incidence of taxation. Taxation experts in early 1920s appointed by the League of Nations describe the method of classification as Contracting States dividing tax sources and tax objects amongst themselves by mutually binding themselves not to levy taxes or to tax only to a limited extent.

English lawyers called it “Classification and Assignment Rule”, whereas German jurists called it the “Distributive Rule”. According to this principle, “to the extent that an exemption is agreed to, its effect is in principle independent of both whether the Contracting States impose tax, in the situation to which the exemption applies, and irrespective of whether the States actually levy tax”. The point here is that having agreed to part the right of tax with the other state, that state may or may not levy tax and if the state in whose favour right to tax is devolved, chooses not to tax such income, then it may result into double non-taxation. The argument in favour of double non – taxation is that income would be subject to tax in the exempt state as and when the exemption is withdrawn, or tax is levied. Thus, it takes care of future liability of tax.

¹³ For discussion of MFN Clause refer to decision of the Apex Court of India in the case of Assessing Officer Circle (International Taxation) 2(2)(2), New Delhi vs. M/s Nestle SA (Supreme Court) [Civil Appeal No.(s). 1420 of 2023]

¹⁴ **Source / Basis:-** Ruling by ITAT in case of ADIT Vs. Green Emirates Shipping & Travels (Mum) (2006) 99 TTJ (Mum.) 988; *Klaus Vogel book on Double Taxation Conventions (Third Edition)*

Prof. Klaus Vogel, commenting on US – German DTAA observed: “Thus, it is said that the treaty prevents not only ‘current’ but also merely ‘potential’ double taxation.”

4.1. *Treaties are entered into for “Mutual Benefits”*

Apart from the allocation of tax between the treaty partners, tax treaties can also help to resolve problems and can obtain benefits which cannot be achieved unilaterally¹⁵

Treaties are negotiated and entered into at a political level and have several considerations as their basis. Thus, treaties should be seen in the context of aiding commercial relations between treaty partners¹⁶.

4.2. *A tax treaty provision may have an unequal effect*¹⁷

State A imposes tax, but state B does not impose a tax, yet wordings of the treaty are reciprocal – so that if and when State ‘B’ introduces such a tax, the treaty rates would be operative in State ‘B’. Until such time there would be an unequal effect.

Example- Mr. U, a resident of ‘UK’ derives dividend income from an Indian company. India – UK DTAA provides that tax charged by India on such dividend income in the hands of the UK resident shall not exceed 15%. However, an Indian company is subjected to Dividend Distribution Tax and the dividend income is exempt in the hands of the recipient (limited exemption¹⁸). Thus, provision of Article 11 on Dividend of India – UK DTAA would be operative if and when India would tax dividend income in the hands of the recipient. The only caveat here is that the Article may be operative presently, in respect of “deemed dividend” u/s 2(22) of the Act as the definition of dividend under the treaty includes “any other item treated as a dividend or distribution “under the taxation laws of that State of which the company making distribution is a resident”.

Another example is India – UAE DTAA, wherein the DTAA provides rate of tax applicable to certain persons on certain income, however, currently there are no taxes on individual or companies (except for banking, oil and gas companies) in UAE¹⁹.

4.3. State ‘A’ may make a distributive rule operative upon fulfilment of certain condition or comparable feature

Example

Indo-Jordan DTAA provides that a capital gain on sale of shares arising to a resident of Jordan is taxed only in Jordan. However, if Jordan does not tax such gain, then the right

¹⁵ David R. Davis in Principles of International Double Taxation Relief (London, Sweet and Maxwell, 1995)

¹⁶ Azadi Bachao Andolan 263 ITR 706(SC)

¹⁷ W. S. Fisher Q. C. in Mathewson

¹⁸ The Finance Act 2016 amended the provisions relating to the taxability of dividend income. As per section 115BBDA of the Act, dividend in excess of Rs. 10 Lakhs per annum received by resident individuals, HUFs and firms shall be taxable at the rate of 10% of the gross amount of such dividend. The domestic law rate of tax for non-residents is 20% irrespective of the dividend amount.

¹⁹ UAE has implemented Corporate Tax with effect from June 1, 2023 wherein a standard rate of 9% has been prescribed for taxable income exceeding AED 375,000.

to tax reverts to India.

3. Interpretation of Tax Treaties

3.1 Introduction: Monist vs. Dualist Views

Tax treaties are signed between two sovereign nations by competent authorities under delegated powers from the respective Governments. Thus, an international agreement has to be respected and interpreted in accordance with the rules of international law as laid down in the VCLT²⁰. These rules of interpretation are not restricted to tax treaties but also apply to any treaty between two countries. So, any dispute between two nations in respect of Article 25 relating to Mutual Agreement Procedure of the OECD Model Conventions (MC)/UN MC has to be solved in the light of the VCLT.

However, when it comes to application of a tax treaty in the domestic forum, the appellate authorities and the courts are primarily governed by the laws of the respective countries for interpretation. In India, even before insertion of Section 90(2) by the Finance (No.2) Act, 1991, with retrospective effect from 1-4-1972, Central Board of Direct Taxes (CBDT) had clarified *vide* Circular No. 333 dated 2-4-1982 that where a specific provision is made in the DTAA, the provisions of the DTAA will prevail over the general provisions contained in the Act and where there is no specific provision in the DTAA, it is the basic law i.e. the provisions of the Act, that will govern the taxation of such income. This position has been upheld in many of the judicial decisions in India. The prominent amongst them are *CIT v. Visakhapatnam Port Trust (1983) 144 ITR 146 (AP)*; *Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)*; *CIT v. Kulandagan Chettiar (P.V.A.L.) [2004] 267 ITR 654 (SC)*.

Thus, in India, the Act provides that where the Indian Government has entered into DTAA's which are applicable to the taxpayers, then the provisions of the Act shall apply to the extent they are more beneficial to the taxpayer.

Internationally this situation is known as Monist View wherein International and National laws are part of the same system of law. Some countries which follow the monist system are: Argentina, Italy, the Netherlands, Belgium and Brazil.

The other prevalent approach is the Dualistic approach wherein International Law and National Law are separate systems and DTAA becomes part of the national legal system by specific incorporation/legislation. Some of the countries that follow Dualistic View are Australia, Austria, Norway, Germany, Sri Lanka, and the UK.

India follows the dualist approach under which an international treaty is not enforceable

²⁰ India is not a party to the VCLT and therefore is not bound *as such* to its Articles 31 to 33 on treaty interpretation. Yet, these provisions have systematically been considered as reflecting customary international law by the International Court of Justice. Further, due importance is given by the authorities to the concepts in VCLT.

unless it has been ratified by the Parliament. That is, the international law is different from national law unlike the 'monist' theory which stipulates that international law automatically becomes national law. The special procedure under section 90(1) of the Act for notification by the Central Government to implement double tax agreements evidences this approach.

Interpretation of any statute, more so international tax treaties requires that we follow some rules of interpretation. In subsequent paragraphs we shall deal with rules of statutory construction.

3.2 Basic Principles of Interpretation of a Treaty

Principles or rules of interpretation of a tax treaty would be relevant only where terms or words used in treaties are ambiguous, vague or are such that different meanings are possible. If words are clear or unambiguous, then there is no need to resort to different rules for interpretation.

Prior to the Vienna Convention, treaties were interpreted according to the customary international law. Just as each country's legal system has its own canons of statutory construction and interpretation, likewise, several principles exist for the interpretation of treaties in customary international law. Some of the important principles of Customary International law in interpretation of tax treaties are as follows:

(i) *Golden Rule - Objective Interpretation:*

Ideally any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind. **The term has to be interpreted contextually.**

Words and phrases are in the first instance to be construed according to their plain and natural meaning. However, if the grammatical interpretation would result in an absurdity, or in marked inconsistency with other portions of the treaty, or would clearly go beyond the intention of the parties, it should not be adopted²¹.

(ii) *Subjective Interpretation*

Under this approach, the terms of a treaty are to be **interpreted according to the common intention of the contracting parties** at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.

In Abdul Razak A. Meman's case²², the Authority for Advanced Rulings [the AAR] relied on the speeches delivered by the Finance Ministers of India as well as UAE to arrive at the intention of parties in signing the India-UAE Tax Treaty.

²¹ Prof. J. G. Starke in Introduction to International Law 10th Edition Page-478

²² [2005] 276 ITR 306 the AAR

(iii) Teleological or Purposive Interpretation:

In this approach the treaty is to be **interpreted so as to facilitate the attainment of the aims and objectives of the treaty**. This approach is also known as the 'objects and purpose' method.

In case of *Union of India v. Azadi Bachao Andolan*²³, the Supreme Court of India observed that "the principles adopted for interpretation of treaties are not the same as those in interpretation of statutory legislation. The interpretation of provisions of an international treaty, including one for double taxation relief, is that the treaties are entered into at a political level and have several considerations as their bases." The apex court also agreed with the contention of the Appellant that "the preamble to the Indo-Mauritius DTAA recites that it is for 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty".

(iv) The Principle of Effectiveness:

According to this principle, a treaty should be interpreted in a manner to have effect rather than make it void.

This principle, particularly stressed by the Permanent Court of International Justice, requires that the treaty should be given an interpretation which 'on the whole' will render the treaty 'most effective and useful', in other words, enabling the provisions of the treaty to work and to have their appropriate effects²⁴.

In *Cyril Eugene Pereira*²⁵, the AAR held that "a tax treaty has to be given a liberal interpretation to make it workable but that would only mean ironing out of the creases, as it is called, which would be within the realm of interpretation."

(v) Principle of Contemporanea Expositio

A treaty's terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.

In *Abdul Razak A. Meman's case*²⁶, the AAR observed that "there can be little doubt that while interpreting treaties, regard should be had to material contemporanea expositio. This proposition is embodied in article 32 of the Vienna Convention, referred to above, and is also referred to in the decision of the Hon'ble Supreme Court in *K. P. Varghese v. ITO* [1981] 131 ITR 597."

(vi) Liberal Construction

It is a general principle of construction with respect to treaties that they shall be

²³ 263 ITR 706 (SC)

²⁴ Prof. J. G. Starke in *Introduction to International Law* 10th Edition Page-478

²⁵ [1999] (239 ITR 650), the AAR

²⁶ [2005] 276 ITR 306, the AAR

liberally construed so as to carry out the apparent intention of the parties.

In *John N. Gladden v, Her Majesty the Queen*²⁷, the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed: “*Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated in so far as the particular item under consideration is concerned.*”

The Court further recognised that “*we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament, it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms.*”

(vii) *Treaty as a Whole – Integrated Approach*

A treaty should be construed as a whole, and effect should be given to each word which would be construed in the same manner wherever it occurs. Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.

To quote Prof. Roy Rohatgi²⁸:

- (a) tax treaties tend to be less precise and require a broad purposive interpretation;
- (b) the purpose is not the same as the subjective intention of Contracting States. It refers to the goals of the treaty as reflected objectively by the treaty as a whole.

(viii) *Reasonableness and consistency*²⁹

Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument. In accordance with the principles of consistency, treaties should be interpreted in the light of existing international law.

One thing may be noted regarding the rules of interpretation, that they are not rules of law and are not to be applied like the rules enacted by the legislature in an Interpretation Act. In *Maunsel v. Olins*, Lord Reid observed that “They are not rules in the ordinary sense of having some binding force. They are our servants not our masters. They are aids to construction, presumptions or pointers. Not infrequently one ‘rule’ points in one direction, another in a different direction. In each case, we must look at all relevant circumstances and decide as a matter of judgment what weight to attach to any particular

²⁷ 85 D.T.C. 5188 at 5190, Source: UOI v. Azadi Bachao Andolan 263 ITR 706 (SC) page: 742

²⁸ “Basic Principles of International Taxation” Vol I

²⁹ Prof. J. G. Starke in Introduction to International Law 10th Edition Page-478

'rule'.³⁰

3.3 Extrinsic Aids to Interpretation of a Tax Treaty

A wide range of extrinsic material is permitted to be used in interpretation of tax treaties. According to Article 32 of the Vienna Convention the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.

3.3.1 According to Prof. Starke one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted:

- (i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;
- (ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];
- (iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;
- (iv) Other treaties, in pari materia, in case of doubt.

Provisions in Parallel Tax Treaties

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y?

In case of Raymond Ltd.³¹ the Hon. Tribunal relied on the examples given in the Memorandum of Understanding concerning Fees for Included Services in respect of Article 12 of the India-US Tax Treaty while interpreting the concept of "make available" under the India-UK Treaty as the language used in both the treaties is similar.

However, the view of the Indian Judiciary is not consistent in this respect. There are contradictory judgments by Indian courts/tribunal in this regard as mentioned below:

- For: (i) UOI v. Azadi Bachao Andolan (2003) 263 ITR706 (SC)
- (ii) AEG Telefunken v. CIT (1998) 233 ITR 129 (Kar)
 - (iii) P. No. 28 of 1999, In re (2000) 242 ITR 208 (AAR)
 - (iv) P. No. 16 of 1998, In re (1999) 236 ITR 103 (AAR)

³⁰ [1975] 1 ALL ER 16 (HL). Referred in Utkal Contractors and Joinery Pvt. Ltd. v. State of Orissa AIR 1987 3 SCC 279, page 290 and also in Keshavji Ravji & Co. v. CIT (1990) 183 ITR 1, pages 11-12.

³¹ [2003] 86 ITD 791 (Mum)

(v) DCIT v. Boston Consulting Group Pte. Ltd. (2005) 93 TTJ 293 (Mum)

Against:

- (i) Mashreq Bank PSC v. DDIT (2007) 108 TTJ554 (Mum)
- (ii) CIT v. PVAL Kulandagan Chettiar (2004) 267 ITR 654 (SC)
- (iii) CIT v. Vijay Ship Breaking Corpn (2003) 261 ITR 113 (Guj.)
- (iv) Essar Oil Ltd. v. JCIT (2006) 102 TTJ 270 (Mum)

3.3.2 Technical Explanation on US MC

US published a detailed technical Explanation accompanying the United States Model Income Tax Convention. This explanation though refers extensively to the OECD Commentary; it highlights differences and provides basic explanation of US treaty policy for all interested parties. In the Indian context, it may be noted that a technical explanation for the India-US tax treaty has been provided which goes a long way in enabling a person to interpret the tax treaty provisions.

3.3.3 International Articles/Essays/Reports

In DCIT v. ITC Ltd, (2003) 85 ITD 162 (Kol) the Tribunal referred to an essay to support its observations. Similarly, in case of CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP), the High Court obtained “useful material” through international articles.

3.3.4 Cahiers published by IFA, Netherlands

Cahiers were relied upon in case of Azadi Bachao Andolan’s(supra) case by the SC.

3.3.5 Protocol

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein. [Sumitomo Corpn. V. DCIT (2007) 110 TTJ 302 (Del.)]

A protocol allows for adjustments to be made to the treaty without the need for renegotiating the entire agreement. This adaptability ensures that the tax treaty remains relevant and effective in the face of changing circumstances. In other words, a protocol is a dynamic tool that allows tax treaties to evolve, adapt to changing circumstances, and effectively address emerging issues. It is used to clarify the meaning and scope of terms in the treaty which may give rise to ambiguity. It is also used for preventing treaty abuse. Its inclusion in a tax treaty demonstrates a commitment to ongoing cooperation and ensures that the treaty remains a relevant and valuable instrument for fostering international trade and investment.

Protocol to the India-US tax treaty provides many examples to elucidate the meaning of the term “make available”. Protocol to India-France treaty contains the Most Favoured

Nation Clause³². Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

3.3.6 Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty. In case of Azadi Bachao Andolan, the Apex Court observed that ‘the preamble to the Indo-Mauritius Double Tax Avoidance Convention (DTAC) recites that it is for the ‘encouragement of mutual trade and investment’ and this aspect of the matter cannot be lost sight of while interpreting the treaty’. These observations are very significant whereby the Apex Court has upheld ‘economic considerations’ as one of the objectives of a Tax Treaty.

Article 6 of the Multilateral Instrument, of which India is a signatory, introduces the object and purpose of a treaty to not create opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements). By inserting the new language in existing treaties, the significance of the Preamble in treaty interpretation is reinforced.

3.3.7 Mutual Agreement Procedure [MAP]

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. MAP is more authentic than other aids as officials of both countries are in possession of materials/documents exchanged at the time of signing the tax treaty which would clearly indicate the object or purpose of a particular provision. Successful MAPs also have persuasive value in case of subsequent applications.

3.4 Commentaries on OECD / UN Models

OECD Model Commentary has been widely used in interpretation of tax treaties. The Commentary on the OECD MC states that: “the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge’s deliberations.” Phillip Baker regards the OECD Commentaries as an aid to tax treaty interpretation in several countries. In *US v. Al Burbank & Co. Ltd.*³³ the US Second Circuit Court of Appeal referred to the Commentaries as an ‘aid to interpretation’.

In *CIT v. Vishakhapatnam Port Trust’s case*³⁴, the Andhra Pradesh High Court observed that “the OECD provided its own commentaries on the technical expressions and the clauses in the Model Convention. Lord Radcliffe in *Ostime v. Australian Mutual Provident Society* (1960) AC 459, 480; 39 ITR 210, 219 (HL), has described the language

³² Refer decision of the Apex Court in the case of Assessing Officer Circle (International Taxation) 2(2)(2), New Delhi vs. M/s Nestle SA (Supreme Court) [Civil Appeal No.(s). 1420 of 2023]

³³ [1975] 525 F 2d 916

³⁴ [1983] 144 ITR 146, page - 157

employed in these agreements as the ‘international tax language.’

OECD has framed a model convention to guide countries to draft DTAA. In the *Azadi Bachao Andolan* case³⁵, the Supreme Court has made reference to the OECD convention while interpreting terms used in DTAA.

Both UN and OECD Model Commentaries are a great help in interpretation of tax treaties. Their importance in interpretation of tax treaties can hardly be over emphasized. [*Credit Lyonnais v. DCIT (2005) 94 ITD 401 (Mum)*]

Model Commentaries give the authoritative interpretation of the provisions of DTAA. [*Sonata Information Technology Ltd. v. ACIT (2006) 103 ITD 324 (Bang.)*]

Commentaries play a crucial role in interpreting and understanding the provisions of tax treaty models. They provide guidance and clarification on the intended meaning of specific articles and help ensure consistent application across different jurisdictions. Commentaries are indispensable tools for interpreting, applying, and updating tax treaty models. They contribute to the clarity and consistency of international tax law, providing valuable guidance to tax authorities, taxpayers, and other stakeholders involved in cross-border transactions.

When the definition of “royalties” is seen in all the DTAA that we are concerned with, it is found that “royalties” is defined in a manner either identical with or similar to the definition contained in Article 12 of the OECD Model Tax Convention. This being the case, the OECD Commentary on the provisions of the OECD Model Tax Convention then becomes relevant. [*Engineering Analysis Centre of Excellence Private Limited [TS-106-SC-2021]*]

UN Commentary reproduces significant part of the OECD Model Commentary but adopts a different approach in certain aspects since some articles in the UN Model Convention also differ from the OECD Model or the UN Committee of Experts felt that the interpretation in the OECD Commentary is not suitable in the context of developing countries. The UN Commentary is also an important aid to interpret treaties, especially those modelled on the UN Model.

3.5 Foreign Courts’ Decisions

In *CIT v. Vishakhapatnam Port Trust’s* case³⁶, the Andhra Pradesh High Court observed that, “in view of the standard OECD Models which are being used in various countries, a new era of genuine ‘international tax law’ is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adoption is just as important as the initial removal of divergences.

³⁵[2003] 263 ITR 706

³⁶ [1983] 144 ITR 146, page - 157

Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant.”

In the under-noted cases, foreign court cases have extensively been quoted for interpretation of treaty provisions:

Union of India v. Azadi Bachao Andolan³⁷

CIT v. Vishakhapatnam Port Trust³⁸

Abdul Razak A. Meman³⁹

3.6 Ambulatory v. Static Approach

Whenever a reference is made in a treaty to the provisions of domestic tax laws for assigning meaning to a particular term, a question often arises what meaning to be assigned to the said term – the one which prevailed on the date of signing a tax treaty or the one prevailing on the date of application of a tax treaty. There are two approaches to the subject, namely, Static and Ambulatory.

Static

Static approach looks at the meaning at the time when the treaty was signed.

Ambulatory

Ambulatory approach provides that one looks to the meaning of the term at the time of application of treaty provisions. All Model Commentaries⁴⁰ including the Technical Explanation on US Model Tax Convention favour ambulatory approach, however with one caution and that is ambulatory approach cannot be applied when there is a radical amendment in the domestic law thereby changing the sum and substance of the term.

India- Australia Treaty, in Article 3(2) adds the expression “from time to time in force” to provide for an “ambulatory” interpretation. Several other India’s treaties contain reference to the domestic law at the time of the application of the treaty concerned, which is again the ambulatory approach.

3.7 Ambulatory Approach subject to Contextual Interpretation

Paragraph 2 of Article 3 (General Definitions) of the OECD MC provides that meaning of the term not defined in the treaty shall be interpreted in accordance with the provisions of the tax laws of the Contracting State that may be applying the Convention. However, this provision is subject to one caveat and that is if the context requires interpreting the term ‘otherwise’, then the meaning should be assigned accordingly. For example, India-

³⁷ [2003] 263 ITR 706 (SC)

³⁸ [1983] 144 ITR 146,

³⁹ [2005] 276 ITR 306 the AAR

⁴⁰OECD Model Commentary Paragraph 11 commentary on Article 3 (2) July 2014 Version

US treaty provides that assignment of meaning under the domestic law to any term not defined in the treaty shall be according to the common meaning agreed by the Competent Authorities pursuant to the provisions of Article 27 (Mutual Agreement Procedure). And if it is not so agreed, only then, the meaning would be assigned from the domestic tax law and that too, provided the context does not require otherwise.

In case of *Union of India v. Elphinstone Spinning and Weaving Co. Ltd*⁴¹, the Supreme Court observed that “when the question arises as to the meaning of a certain provisions in a Statue it is not only legitimate but proper to read that provision in its context. The context means the statute as a whole, the previous state of law, other statutes in *pari materia*, the general scope of statute and the mischief that it was intended to remedy.”

In *Pandit Ram Narain v. State of Uttar Pradesh*⁴², the Supreme Court observed that the meaning of words and expressions used in an Act must take their colour from the context in which they appear.

As per Explanation 3 of section 90 of the Act, any term used but not defined in the Act or in the DTAA, shall, unless the context otherwise requires, and is not inconsistent with the provisions of the Act or the DTAA, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.

Further, in this regard, Finance Act, 2017, has amended the provisions of section 90/90A of the Act by way of insertion of an explanation according to which, the term not defined in DTAA, but defined in the Act shall be assigned the meaning given in the Act and explanation, if any, given to it by the Central Government.

3.8 Objectives of Tax Treaties

Objectives for signing a tax treaty also play a significant role in its interpretation as they determine the context in which a particular treaty is signed. For example, OECD and UN MCs have different objectives to achieve. The same are as follows:

3.8.1 OECD Model Conventions

Principal objectives of the OECD MC are as follows:

The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchange of goods and services and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion⁴³. As a result of work undertaken as part of the OECD/G20 Base Erosion and Profit Shifting Project, in 2014 the Committee decided to amend the title of the Convention and to include a preamble. Article 6 of the MLI prescribes a modification to the existing language of preamble to the tax treaty expressly stating that the purposes

⁴¹ [2003] 4 SCC 139, page-164

⁴² [1956] SCR 664, page-673

⁴³ Paragraphs 15.6 and 54 of the Commentary on OECD Model Tax Convention on Article 1 November 2017 Update

of the Convention are not limited to the elimination of double taxation and that the Contracting States do not intend the provisions of the Convention to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance. This will also depend on how the Contracting States decide to implement their common intention, reflected in the preamble of the Convention and incorporated in the minimum standard agreed to as part of the OECD/G20 BEPS.

3.8.2 UN Model Conventions

The principal objectives of the UN MC are as follows:

- To protect tax payers against double taxation (whether direct or indirect)
- To encourage free flow of international trade and investment
- To encourage transfer of technology
- To prevent discrimination between tax payers as between foreign investors and local taxpayers
- To provide a reasonable element of legal and fiscal certainty to investors and traders within which international operations can confidently be carried on
- To arrive at an acceptable basis to share tax revenues between two States
- To improve the co-operation between taxing authorities in carrying out their duties including exchange of information with a view to prevent avoidance/evasion of taxes and by assistance in collection of taxes.

With this background, tax treaties contribute to the furtherance of the development aims of developing countries. Further, as a result of international focus on base erosion and profit shifting, treaties are not intended to facilitate treaty shopping and other treaty abuses.

3.8.3 Indian Tax Treaties

Section 90 of the Act contains the objectives for which the Central Government may enter into agreement with other countries or territories to accord mutuality of relief, equitable treatment of taxpayers, resolving of conflicts, exchange of information. Some of them are as follows:

- (a) for granting of relief in respect of –
 - (i) income on which taxes have been paid, both income-tax under the Income Tax Act, 1961 ('this Act') and income-tax in that country; or
 - (ii) income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade and investment⁴⁴,

⁴⁴ substituted vide Finance Act, 2003 with effect from 1st April 2004

or

- (b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, “without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to the residents of any other country or territory”⁴⁵; or
- (c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or
- (d) for recovery of income-tax under this Act and under the corresponding law in force in that country.

Thus, it can be observed that there are several objectives for entering into tax treaties by the Government of India besides the primary objective of avoidance of double taxation as enumerated in clause (b) above. Besides avoidance of double taxation, Indian treaties are aimed at achieving two more important objectives, namely, ‘prevention of fiscal evasion and recovery of taxes’⁴⁶.

The amendment made by the Finance Act, 2003, clarifies that the Government may enter into tax treaty for the purposes of ‘promotion of mutual economic relations, trade and investment’. This amendment is more in the nature of clarification because there are several existing treaties whose preambles suggest that they were entered into for the purposes of encouragement of mutual trade and investments and/or promotion of mutual economic relations. For example, treaties with Mauritius, Turkmenistan, UAE, Germany, Ukraine⁴⁷, and Switzerland⁴⁸ are entered into for various economic reasons, besides the objectives of avoidance of double taxation and prevention of fiscal evasion.

3.9 Conclusion

There is a famous saying by one judge in his order. He wrote “Language at best is an imperfect instrument for the expression of human thoughts and emotions”. It is the inadequacy of language which creates lots of communication gaps in application of a tax treaty. Determination of intent of parties, prevalent at the time of entering into

⁴⁵ The text in quotes was inserted by the Finance Act 2020 with effect from 1-4-2021 and contains the same language as found in Article 6 of the Multilateral Agreement (MLI) mandating the text to be part of the preamble to treaties. India is a signatory to the MLI.

⁴⁶ Substance of the CBDT Circular 108 dated March 20, 1973

⁴⁷ One of the objectives of the treaty is mentioned as ‘confirming their aspiration for the development and strengthening of bilateral relations’ – 253 ITR (St.) 54

⁴⁸ Press release dated 16 Feb. 2000 [248 ITR (St.) 158B] on amendment of the Treaty (214 ITR (St.) 223) provides that ‘The agreement will impart new momentum to the continuing Indo-Swiss economic relations particularly mutual investments in the two countries.’

agreement, after considerable lapse of time is a herculean task in absence of “*Travaux Preparatoires*” i.e. preparatory work.

Tax Treaties are result of prolonged negotiations between two Contracting States. Ideally, therefore the same should be interpreted keeping in mind the objectives with which they are entered into. Minutes of negotiations, exchange of notes, letters etc. are important material in determining the object of a particular treaty provision. However, absence of any such document in public domain makes the task of interpretation very difficult.

Interpretation of tax treaties is an evergreen subject of controversy considering the complexities involved. Application of international rules of interpretation while giving effect of provisions under the domestic law creates further confusion. Even courts are not unanimous in their rulings.

4. Legal Systems and Treaty Interpretations

4.1 Introduction

Double Tax Avoidance Agreement (DTAA) is entered into between the two countries. The basic objectives of any DTAA are to avoid double taxation, to provide assistance in recovery of taxes, exchange of information, and resolving tax disputes. As mentioned earlier, it is to be noted that DTAA provides distributive rules, but computation of income will be as per provisions of the domestic tax laws and therefore it differs from country to country.

4.2 Judicial Approach

Broadly, there are two types of systems which are followed by countries across the globe. The systems are as follows –

- Civil law system

The countries following this system rely on sources such as laws, treaties, regulations, jurisprudence and doctrines. They tend to stress the exact wording of the law and generally the legal reasoning is strict.

- Common law system

The source for settling the matter is similar. However, the exceptions are that common law system gives more emphasis to judicial decisions which have precedential value and treats doctrinal writings largely as persuasive.

4.3 Types of interpretation

In deciding a particular matter, the Courts use various tools which enable them to decide a particular matter. Principles of interpretation are largely used. Treaty interpretations are broadly of the following nature –

- *Literal*

Matters are decided in this system by merely looking at the text of the treaty. In construing statutes the cardinal rule is to construe its provisions literally and grammatically giving the words their ordinary and natural meaning. This rule is also known as the plain meaning rule. By following this system, stability and certainty is guaranteed but the effectiveness may be reduced.

- *Legislative*

Under this system, what is considered is only the purpose of the legal provision without having regard to the literal reading of the law. For this system, all the latest developments in the judicial and legislative fields are covered for the purpose of interpretation.

- *Mischief*

The mischief rule of statutory interpretation is the oldest of the rules. The mischief rule is a rule of statutory interpretation that attempts to determine the legislator's intention. Its main aim is to determine the "mischief and defect" of the statute.

- *Purposive*

Substance over form is preferred through a contemporary purposive interpretation. Economic and social purpose is considered and a look at the purpose of the legislation is considered beyond what is contemplated in the words of the treaty.

As per the recent trends in the judicial landscape, the Courts/ Tribunals have been following the principle of substance over form while adjudicating a case (i.e., whether the essence of the agreements matches the actual conduct)⁴⁹.

Various Court rulings have confirmed different approaches to interpretation. Some of the decisions have been provided below.

4.3.1 Country wise examples

- *Canada*

In the case of *Crown Forest Industries Ltd. v. The Queen* [1995] 2 SCR 802 (22 June 1995), it was held that Article 31 and 32 – extrinsic material – may be referred for the purpose of interpretation.

- *Australia*

In the *Thiel* case,⁵⁰ it has been provided that VCLT codifies international law qua

⁴⁹ CIT vs. Formula One World Championship Ltd. [2017] 80 taxmann.com 347 (SC); Google India (P.) Ltd. V. Additional Commissioner of Income Tax [2023] 149 taxmann.com 7 (Bangalore - Trib.); Huawei Technologies Co. Ltd. V. Additional Director of Income Tax (International Taxation) [2020] 122 taxmann.com 130 (Delhi - Trib.)

⁵⁰ Thiel v. Federal Commissioner of Taxation (1990) 171 CLR 338

treaties. Hence, a reference may be made to VCLT.

- *France*

In the history of French taxation, the dispute resolution mechanism adopted appears to be a little different from the general understanding. Until 1990, the Courts in France were not entitled to pronounce any ruling in relation to the treaties unless the meaning was not clear. It was the Ministry of Foreign Affairs which could give a ruling qua the treaties. However, times have changed and now, the rulings of the Ministry are no longer binding. In other words, it is the Courts which are now entitled to interpret. Generally, a strict literal interpretation is called for by the French Constitution. In case of doubt, rulings are generally against the revenue (i.e. French tax authorities).

- *India*

In India, a mixed approach to Treaty interpretation has been followed. However, it has been held in various cases that effect must be given to the provisions/ words of the treaty or the domestic tax law. The principles of harmonisation, the purposive approach, etc. must be applied only when there is any ambiguity or the literal interpretation would lead to absurd consequences.

- May be taxed⁵¹ vs. shall be taxed

Nevertheless, various Court rulings have construed the treaty liberally on various occasions. The Supreme Court in Chettiar's case [(2004) 267 ITR 654]⁵², in the context of India – Malaysia tax treaty has held that if a right is given to the source country by using the words 'may be taxed', it therefore implies that there would be no levy of tax on such income in the country of residence. India is not a signatory to the VCLT but follows VCLT rules as codification of customary international law. The Supreme Court of India, in its ruling held that in order to interpret a treaty, intentions of the party must be ascertained, and it is necessary to interpret the treaty liberally. However, it may be noted that subsequent to this ruling, CBDT issued a Notification No. 91/ 2008 dated 28th August, 2008 providing that where any treaty provides that 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, subject to relief under the articles on elimination of double taxation.

- Specific inclusion of words such as 'beneficial owner' and limitation of benefit – Special reference to the Azadi Bachao Andolan Case

In Azadi Bachao Andolan case, the Delhi High Court provided that 'treaty shopping'

⁵¹ Terminology used in most of the tax treaties of India

⁵² The ratio of this decision is however not applicable any more since CBDT has issued a notification which provides that the expression must be construed as 'shall be taxed'.

cannot be permitted since the same, although legal, cannot be given effect to since it vitiates the very purpose of treaty relief being 'granting relief from double taxation only to residents of treaty partners'. This decision was however, overruled by the Supreme Court. Before the Supreme Court, it was argued that the India – Mauritius DTAA is being used by persons who are residents of countries other than Mauritius. The only purpose of investing through Mauritius is to avail the benefit of Article 13(4) (on capital gains) and no other genuine commercial purpose exists. The Supreme Court in the decision stated that a tax treaty is a compromise by the countries (i.e. treaty partners) for the purpose of economic growth and development. **Concepts of 'beneficial owner' and 'limitation of benefits' shall be imported into the treaty only when the language of the treaty permits such a construction.** The Supreme Court also referred the title of the India – Mauritius treaty which reads that *"avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment"* (Emphasis supplied). It went a step further to provide that the India – Mauritius treaty is used by residents of other countries is a *fait accompli* considering the benefits available under the tax treaty. If treaty shopping is to be discouraged, the same ought to be provided by way of suitable terms and conditions in the treaty by amending the same.

- **Look through vs. Look at – The Vodafone Case**

Facts

Hutchison group (Hong Kong) had a subsidiary company incorporated in Cayman Islands. Through the Cayman subsidiary, the Hutch group, through a chain of multiple companies had equity interest of about 52% in an operating company in India and through various shareholder agreements, had an interest of approximately 15% of the equity interest in the said operating company. Vodafone, a foreign, non – resident company had acquired shares of the Cayman Island Company. It was this acquisition in the Cayman Island Company which enabled Vodafone to enter in India.

Thus, it was a case where a non-resident company (Hutch parent) had transferred shares of a non-resident company (Cayman Island subsidiary) to another non-resident company (Vodafone).

Revenue's Contention

It contended that Vodafone has entered in India through acquisition of Cayman Island Company. What is sought to be transferred is the interest/ stake/ assets of the Indian company by using the holding-subsiary structure. It relied on the declaration of the Vodafone group which was given to the London stock exchange that it is acquiring stake in operating company in India. Similar declaration was made by the Hutch group to the stock exchange in the U.S. It was also argued that

the valuation of the acquisition of the Cayman Company derives its substantial value from the Indian Operating Company and hence, tax incidence must be borne in India.

Vodafone's Contention

Vodafone argued as follows –

- (a) It was the shares of Cayman Island Company that was acquired. Shares of a Company are situated at the place of incorporation or where the register of shareholders has been kept. In the present case, shares (asset) are situated outside India and consequently there is no tax liability in India.
- (b) Even if a subsidiary is wholly owned, it has a separate legal status distinct from its parent. It is only in certain circumstances that the corporate veil may be lifted to disregard the holding subsidiary corporate structure. Under the tax laws, form is to be given respect if the purpose is genuine. It is only when the facts reveal otherwise than the form that the corporate veil shall be lifted. In other words, if the shareholder assumes responsibility beyond the normal capacity of the shareholder, only then the veil may be lifted.
- (c) In spite of acquisition of Cayman Island Company, ownership (Mauritius Companies⁵³) of the Indian Company is still the same.

Supreme Court's decision

The Court inter-alia observed that a transaction must be looked at in its entirety. A dissecting approach adopted would lead to absurd and unintended consequences. The deeming fiction under a statute is for specific purposes and therefore, a strict interpretation is required. The indirect transfers were sought to be taxed under the Draft Direct Tax Code bill, however, the same is not the case under the Income – tax Act, 1961. It further held that if the intention was to target such transfers, it must be specifically provided under the law.

The Vodafone aftermath

Subsequent to the decision, the Finance Act, 2012 inserted explanation 5 to section 9(1)(i) of the said Act which provides that indirect transfers of “shares or interest in a company or entity registered or incorporated outside India” are deemed to be situated in India (and thus, income from such transfers become taxable under the Act) where such “shares or interest” derives their value substantially from the assets located in India.

⁵³ Immediate parent of the Indian Operating companies in the Corporate ownership structure

5. Model Tax Conventions

5.1 Introduction

- Global trade and commerce have made the world truly a single integrated market. In today's scenario, no Country can claim that it is self-sufficient. This gives rise to import and export of goods and services.
- As and when the global trade started expanding its operations, economic transactions triggered tax provisions of various jurisdictions.
- In the absence of any agreement for avoidance of double taxation, the global business environment was affected. Therefore, a need was felt that there must be formulated a convention which would enable avoidance of double taxation.
- This led to series of model tax conventions by various bodies in different years (these models have been discussed in the subsequent part of the chapter). Consequently, in order to give an impetus to the global trade and commerce, various Countries started negotiating tax treaties.
- In the present environment, post the OECD G20 BEPS⁵⁴ project initiative; existing tax treaties are being amended not only for the purpose of avoidance of double taxation, but also for the purpose of avoiding double non-taxation or reduced taxation.
- Working together in the OECD/G20 Inclusive Framework on BEPS, over 135 countries (including India) and jurisdictions are implementing 15 Actions to tackle tax avoidance, improve the coherence of international tax rules, ensure a more transparent tax environment and address the tax challenges arising from the digitalisation of the economy.

5.2 Treaty Models

Presently, the following are the model tax conventions which are in vogue –

(Of these, the first three are the most prominent and often used models. However, a double taxation avoidance agreement could be a combination of different models.)

5.2.1 OECD Model

The emergence of present form of OECD MC can be traced back to 1927, when the Fiscal Committee of the League of Nations prepared the first draft of Model Form applicable to all countries. In 1946 the model convention was published in Geneva by the Fiscal Committee of U.N. Social & Economic Council and later by the Organisation for European Economic Co-operation (OEEC) in 1963. However, in 1961, the

⁵⁴ Base Erosion Profit Shifting

Organisation for Economic Co-operation and Development (OECD) was established, with developed countries as its members, to succeed the OEEC, and OECD approved the draft presented to the OEEC. In 1977, the final draft was prepared in the present form which has been revised several times; the latest being in the year 2017.

OECD Model is essentially a model treaty **between two developed nations**. This model advocates residence principle, that is to say, it lays major emphasis on the right of state of residence to tax the income.

India is not⁵⁵ a member of OECD but recently the Indian Courts and Tribunals have been following the relevant observations from OECD Commentaries while delivering the judgments. Further, various countries including India have given some observations/reservations⁵⁶ on various Articles under OECD Model.

5.2.2 UN Model⁵⁷

The work performed by the League of Nations was taken over by the United Nations from the year 1945. In the year 1945, post-World War – II, the United Nations was formed with a view to promote international co-operation. Various committees were formed, sessions were held and bilateral model convention was drafted. The latest model convention was updated in the year 2017⁵⁸. The UN MC provides a Model Tax Treaty between a developing nation and a developed nation. The emphasis here is on 'source base' taxation, the reason being the flow of capital and technology from the developed nation to the developing nation. Indian tax treaties, by and large follows UN MC.

5.2.3 The U.S. Model

The U.S. Model is different from OECD and UN MC in many respects. However, it is worth noting that it is predictably closer to the OECD MC. The India –US treaty provides for Limitation on Benefits (Article 24), which is unique to this treaty. Further, the capital gains article (Article 14) provides that tax on capital gains shall be levied in accordance

⁵⁵ India participates in selected OECD Committees and their subsidiary bodies. India is also a member of the Development Centre, the Global Forum on Transparency and Exchange of Information for Tax Purposes, the International Transport Forum, the Financial Action Task Force, and an Association Country of the International Energy Agency. Engagement in the G20 context includes India's active role in the Global Forum on Steel Excess Capacity and its adherence to the G20/OECD Principles of Corporate Governance. Indian ministers and officials have also attended the OECD Ministerial Council Meetings. Source: <https://www.oecd.org/india/indiaandtheoecd.htm>

⁵⁶ Observations and reservations are the areas where the countries/ jurisdictions disagree with the contents of the Articles or the Commentary of the OECD Model Tax Convention

⁵⁷ <http://www.un.org/esa/ffd/documents/DoubleTaxation.pdf>

⁵⁸ Updated in 2021, The United Nations, through its Committee of Experts on International Cooperation in Tax Matters, approved recommended language for bilateral treaty rules to address taxing rights around income arising from Automated Digital Services (ADS). The new Article 12B and associated Commentary forms part of the 2021 version of the UN Model Tax Convention.

with the domestic laws of the respective contracting states.

5.2.4 The Andean Model

It is a regional level model convention developed in 1971. A group of lesser and medium developed Latin American countries have adopted this Model, namely, Bolivia, Columbia, Chile, Ecuador, Peru, and Venezuela. It provides for almost exclusive taxation in source country, except, in cases of international traffic. The Permanent Establishment concept is not incorporated. This model is not used by other countries.

6. Bilateral Tax Treaties

6.1 Introduction

- As discussed in the model tax convention chapter, it is clear that Governments, based upon the model conventions negotiate and enter into a tax treaty (comprehensive or otherwise).
- Treaty represents various compromises agreed upon by the respective contracting states depending upon the economic expediency of a particular country.
- Tax, in the country of source is considered as a cost, whereas an obligation in the country of residence. Therefore, under the tax treaty framework, it is provided that the country of source will limit/ restrict its taxing right and the country of residence in return will grant credit for the taxes paid in the source country. Generally, the credit is given with the condition that tax must have been paid in the country of source in accordance with the provisions of the treaty, except where the treaty provides for a tax sparing clause. In case of tax sparing, the country of residence gives credit of taxes which are spared by the source country. Thus, any income which is exempt in the country of source, then it is assumed that tax is paid and credit is given on deemed basis.
- A bilateral tax treaty, unlike the domestic tax law, is an agreement between two countries. To interpret the treaty, it is essential to understand the intention of the contracting parties.
- Tax treaties provide for allocation of taxing rights between the contracting states. It is pertinent to note that treaty provisions usually work on non-aggravation principles. In other words, if an income is not taxable under the domestic tax law; such income cannot be taxed even if it is so taxable in accordance with tax treaty provisions. Thus, generally, no new charge to tax can be created under the treaty.

6.2 Objectives of a tax treaty

- The primary intention of the countries is to allocate taxing rights and avoid the evil brunt of two-fold (double) taxation. However, many a times, twofold taxation is

inevitable. In such cases, the hardship caused is somewhat mitigated by providing credit for the tax paid in the country of source. In order to advance the object of avoiding/ reduce the hardship caused by double taxation, the following are some of the factors considered in tax treaties –

- i. Scope of the treaty, taxes covered, entities covered;
- ii. Determination of residential status of a person to determine whether a person is entitled to treaty benefits and thus, for any tax credit provided for in the concerned treaty;
- iii. Provision for reduced rate of tax in the state of source;
- iv. Determination of how income of individuals such as salary, capital gain, etc. would be allocated for taxation between the Contracting States;
- v. Provision for procedural framework for enforcement, availing credit of taxes paid, collection of taxes and dispute resolution, etc.

6.3 Basic features⁵⁹ of tax treaty

6.3.1 Tax residency

Benefits of tax treaty would be available only if the person is a resident of one or both of the contracting states. Generally, it is article 4 of the tax treaty which governs resident provisions.

In some cases, due to differences in the residential rules⁶⁰ of the treaty countries, there are likely chances that a person may be considered to be a resident of both the contracting states. In such cases, individuals would be considered to be resident of the contracting state in accordance with article 4(2) of the treaty whereas in case of persons other than individuals, article 4(3) of the treaty, commonly referred to as ‘tie breaker rule’ would determine ultimately the residential status of such person.

Exception

One such exception is article 4(3) of the India – U.S. DTAA which provides that “*where, by reason of paragraph 1, a company is a resident of both Contracting States, such company shall be considered to be outside the scope of this Convention except for purposes of paragraph 2 of Article 10 (Dividends), Article 26 (Non-Discrimination), Article 27 (Mutual Agreement Procedure), Article 28 (Exchange of Information and Administrative Assistance) and Article 30 (Entry into Force)*”.

By virtue of the Multilateral Instrument (“MLI”) signed by the countries under the OECD -BEPS initiative, in cases of dual residence, Paragraph 1 of Article 4 (which intends to

⁵⁹ Illustrative features

⁶⁰ India follows financial year whereas the U.S. follows calendar year basis for the purpose of taxation

give effect to the recommendations of Action 6 of the BEPS project by providing for modification of the tie-breaker test for persons other than individuals) provides that, where a person other than an individual is a resident of more than one contracting jurisdiction, the residential status of such person shall be determined mutually by the competent authorities of these contracting jurisdictions.

6.3.2 Allocation of taxing rights

Generally, Articles 6 – 22 of the OECD/UN Models provide the distributive rules with respect to various kinds of income for the purpose of allocation of taxing rights to the country of source and the country of residence. The characterisation of a particular income is guided by these distributive rules contained in these Articles.

6.3.3 Tax Credit mechanism

Under this system, the harshness of double taxation is either eliminated or is restricted. Presently, there are two methods in vogue i.e., the credit method⁶¹ or the exemption method. In some cases, certain types of income are relieved from double taxation by using the credit method while some get relieved from double taxation by using the exemption method. Further, it is possible that the treaty partners (i.e., Country A and Country B) may each use different methods to grant relief from double taxation to its residents.

Difficulties arise in cases of timing mismatch i.e., where two countries follow different tax years, proof of tax payment, rate of currency conversion, computation mechanism, etc. Many of these aspects lack clarity and therefore results in litigation.

6.3.4 Exchange of Information

In an era where tax evasion and tax avoidance are heavily targeted by Governments the world over, this Article assumes significance. As per this Article, the competent authorities of the Contracting states shall exchange such information as is foreseeably relevant for carrying out the provisions of this agreement. The information may not be limited to that which is taxpayer specific and could include information related to tax administration and compliance improvement, for example, risk analysis techniques or tax avoidance or evasion schemes. With some of the countries with which India does not have tax treaty in place, it has Tax Information Exchange Agreement (TIEA) which is usually different from a tax treaty and comprises of Articles focusing on exchange of information, possibility of declining request for information, tax examination board etc. Some of the countries with which India has TIEA are Argentina, Bahamas, Bahrain, Guernsey etc.

⁶¹ Indian treaties by and large follow credit method for elimination of double taxation

6.3.5 Limitation of benefits

Limitation of benefits is yet another powerful anti – avoidance provision in a tax treaty. India has taken an aggressive stand on anti – avoidance and has included limitation of benefits article in its treaties with the USA, Singapore, U.A.E, Mauritius, etc. Treaty shopping, although legal, is frowned upon by various countries, including India. With Article 7 of the MLI dealing with Prevention of treaty abuse, the signatories to the MLI are mandated to adoption of at least one alternative from the following three alternative rules for prevention of treaty abuse-

- i. A principal purpose test ('PPT')
- ii. A PPT supplemented with a simplified limitation of benefits ('SLOB')
- iii. Detailed limitation of benefits (LOB) with rules to address conduit financing structures

The above concepts would be discussed in more detail under the heading BEPS and in other relevant portions in ensuing Chapters of this Module.

7. Multilateral Tax Agreements

7.1 Introduction

The use of DTAA to avoid the harmful effects of double taxation and promote the growth of trade and commerce is well-known. However, commercial activities at the global level involve interaction of multiple countries with one another. DTAAs are frequently bilateral in nature. These bilateral tax treaties require negotiation with each country. This negotiation consumes a lot of time to be fully effective. Thus, bilateral DTAA has its own limitations. This calls for a new treaty which is multilateral in nature. Presently, there are a few multilateral conventions. However, they are limited to a few South American countries, Caribbean Countries, etc. A multilateral convention must have the ability to allocate profits between multiple jurisdictions. This allocation should not result in double taxation without any credits/ reliefs. Further, at the same time there must not be any double non-taxation or double-deduction.

7.2 Types of Multilateral Conventions

Presently, some of the Multilateral Conventions are as follows –

7.2.1 Andean Convention⁶²

Four South American countries presently are the members of the pact. Countries such as Brazil, Argentina, Paraguay, Uruguay, and Chile are granted status of associate

⁶² Basic International Taxation – Second Edition – Volume I: Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

members. The aim is, inter – alia, to establish source-based taxation.

7.2.2 CARICOM Multilateral tax agreement⁶³

An agreement entered into by various Caribbean countries. This agreement, based on similar lines of Andean model provides for source based taxation. Various other provisions are in place for governing taxation in member countries.

7.2.3 EUROPEAN UNION VAT REGIME

Most member states already had a system of VAT before joining the EU but for some countries, such as Spain, VAT had to be introduced along with the membership of the EU. In 1977, the Council of the European Communities sought to harmonize the national VAT systems of its member states by issuing the directives to provide a uniform basis of assessment and replacing the directive promulgated in 1967. In 2006, the Council sought to improve upon the directives by recasting it. The European Union value added tax (or EU VAT) is a value added tax on goods and services within the European Union (EU). The EU member states are each required to adopt a value added tax that complies with the EU VAT code. Different rates of VAT apply in different EU member states. Some of the VAT collected by member states is used to fund the European Union as part of the system of "own resources". EU VAT (known as "output VAT", that is, VAT on its output supplies) is charged by a business and paid by its customers. VAT that is paid by a business to other businesses on the supplies that it receives is known as "input VAT" (that is, VAT on its input supplies). A business is generally able to recover input VAT to the extent that the input VAT is attributable to (that is, used to make) its taxable outputs. Input VAT is recovered by offsetting it against the output VAT for which the business is required to account to the government, or, if there is an excess, by claiming repayment from the government. The final consumer does not receive a credit for the VAT paid. The net effect of this is that each supplier in the chain remits tax on the value added, and ultimately the tax is paid by the end consumer.

⁶⁴In October 2017, the European commission launched plans for the biggest reform of EU VAT rules. The reboot would improve and modernize the system for governments and businesses. The proposed VAT reform would also make the system more robust and simpler to use for companies. The Commission wants a VAT system that helps European companies to reap all the benefits of the Single Market and to compete in global markets. The Commission proposes to fundamentally change the current VAT system by taxing sales of goods from one EU country to another in the same way as goods are sold within individual Member States. This will create a new and definitive VAT system for the EU. The legislative proposal will be sent to the Member States in the Council for agreement and to the European Parliament for consultation. The

⁶³ Basic International Taxation – Second Edition – Volume I: Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

⁶⁴ Source: European Commission - Press release dated 4 October 2017

Commission will follow this initiative in 2018 with a detailed legal proposal to amend the so-called 'VAT Directive' at technical level so that the definitive VAT regime proposed can be smoothly implemented.

7.2.4 G20⁶⁵ OECD BEPS⁶⁶ Action Plan 15

The above tax agreements, except for the EU VAT regime, comprise countries within a particular region and the number of countries involved is very few. Various issues such as double non-taxation and reduced taxation are not yet resolved. Treaty shopping still continues.

In order to implement the several treaty-based measures to tackle BEPS in a speedy and efficient manner without having to renegotiate more than 3000 bilateral tax treaties, Action 15 of the BEPS project envisaged drafting of a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.

The first multilateral convention was presented on 24th November 2016. On 7 June 2017, 68 countries signed the *"Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting"* (hereinafter referred to as MLI) in Paris. MLI is considered as one of the key outcomes of the BEPS project which would ensure implementation of the recommendations of the Action plans. The MLI would work as a guide for jurisdictions to choose from the given recommendations and also to mandate compliance with minimum standards.

The MLI will apply only to jurisdictions who have signed it, who have ratified the same in accordance with their domestic law and subsequently deposited it with the OECD depositary and 3 months have passed from the date five instruments of ratification have been deposited with the depositary for bringing the MLI into force. To date, 101⁶⁷ jurisdictions have joined the BEPS MLI, out of which 85 jurisdictions have ratified, accepted, or approved the BEPS MLI, and it covers around 1900 bilateral tax treaties. Where both the parties are signatories to MLI, their tax treaty would be a covered tax agreement.

India had signed the MLI in Paris on 7th June, 2017 to implement tax treaty related measures to prevent BEPS. On 25 June 2019, India has also deposited its instrument of ratification on MLI with OECD Depositary along with the final list of reservations and notifications. For India, the MLI has entered into force on 1st October, 2019.

⁶⁵ Group of twenty countries

⁶⁶ Base Erosion and Profit Shifting

⁶⁷ Source: <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>

8. European Union

8.1 Introduction

The European Union (EU) is a politico-economic union of 28 member states located primarily in Europe. It operates through a system of supranational institutions and intergovernmental-negotiated decisions by the member states. Some of the institutions are (i) The European Parliament (ii) the European Council (iii) the Council of the European Union (iv) the European Commission (v) the Court of Justice of the European Union (vi) the European Central Bank and (vi) the Court of Auditors. The European Parliament is elected every five years by EU citizens.

8.2 Single Integrated Business Market

A single market has been developed through a standardised system of laws applicable in all member states. EU policies aim to ensure the free movement of people, goods, services, and capital, enact legislation in justice and home affairs, and maintain common policies on trade, agriculture, fisheries and regional development. The monetary union was established in 1999 and came into full force in 2002. It is currently composed of 19 member states that use the euro as their legal tender.

8.3 History

The Maastricht Treaty established the European Union under its current name in 1993 and introduced European citizenship. One of the major amendments to the constitutional basis of the EU was the Treaty of Lisbon that came into force in 2009.

The EU covers about 9.94% of the world population⁶⁸. In the year 2016, the EU generated a nominal Gross Domestic Product (GDP) of 16.518trillion US dollars⁶⁹. Additionally, 27 out of 28 EU countries have a very high Human Development Index⁷⁰.

In 2012, the EU was awarded the Nobel Peace Prize. Through the Common Foreign and Security Policy, the EU has developed a role in external relations and defence. The union maintains permanent diplomatic missions throughout the world and represents itself at the United Nations, the WTO, the G7, and the G-20. The European Union is so influential that it has been described as a current or as a potential superpower.

⁶⁸ <http://www.worldometers.info/world-population/europe-population/>

⁶⁹ [https://en.wikipedia.org/wiki/List_of_countries_by_GDP_\(nominal\)](https://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal))

⁷⁰ https://en.wikipedia.org/wiki/List_of_countries_by_Human_Development_Index

8.4 European Union Business Code of Conduct

8.4.1 European Union Business Code of Conduct, Year 1997⁷¹

In the year 1997, a meeting conducted by the ECOFIN⁷² Council had formed a Code of Conduct. This Code of Conduct, although was not binding on the member states. A broad framework was designed which covered the regulatory, tax and other legislative and administrative aspects. The measures seek to identify the harmful measures which include the following –

- Effective tax which is lower than the general level of tax;
- Benefits reserved for non-residents;
- Offshore activities which do not affect the national tax base;
- Benefits granted regardless of economic activity being carried on in the country;
- Inadequate transparency; and
- Departure from the internationally accepted rules by companies to determine taxable profits in particular those determined by OECD.

8.4.2 European Union Business Code of Conduct, Year 2003⁷³

Even after implementing the code of conduct regime, it was identified that there are certain harmful measures prevailing in the union. These harmful activities are as follows-

- Remove, amend or phase out the incentives provided among the member states and their dependent and associated territories;
- Abolish withholding tax on interest and royalties between the EU group companies from January, 2004; and
- Withholding tax on income of individuals from January, 2005.

On 1st December 1997, the Council and the representatives of the governments of the member states, meeting within the Council, adopted a resolution on a Code of Conduct for business taxation⁷⁴, with the objective to curb harmful tax competition.

In 2008, the ECOFIN Council endorsed the idea that the development or revision of guidance notes could help build on the results of the Group. A number of such guidance notes were agreed by the Group and endorsed by the Council over the years. Their implementation by member states is regularly reviewed by the Group. The Code of

⁷¹ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

⁷² Ministers of Economic and Financial affairs from the EU Member states

⁷³ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

⁷⁴Source: <http://www.consilium.europa.eu/en/council-eu/preparatory-bodies/code-conduct-group/>

Conduct Group has also prepared a number of Council conclusions, including on the EU list of non-cooperative jurisdictions for tax purposes - adopted by the ECOFIN Council on 5th December 2017. As endorsed by the ECOFIN Council on 8th November 2016, the Code of Conduct Group, supported by the GSC, conducts and oversees the screening process, whilst the Commission services assist the Group by carrying out the necessary preparatory work.

8.5 European Union Tax Directives⁷⁵

The EU has played a major role in formulating the tax laws under the EU Member states. Various policies and frameworks are considered to be at the heart of the tax systems of the member states. Some of the directives under the EU tax directive are provided below.

8.5.1. Parent – Subsidiary Directive

The directive aims at eliminating double taxation which happens on account of tax on dividends and other distributions by the subsidiary company to its parent (individuals excluded). The directive was applicable only when the group affiliates were situated within the EU Member States.

8.5.2. Merger Directive

The merger directive provides that mergers, divisions, transfer of assets and exchange of shares by companies within the EU Member States must be tax free between the companies incorporated in the EU member states. The key principles provide the following –

- (a) The state of the transferor will not recognise any gains on the transfer of assets and liabilities in a merger or transfer. Profits will be taxed as income of a permanent establishment. In case of loss, the same will be retained for future offset against the profits of the permanent establishment.
- (b) The state of shareholders of the transferor company will not recognise any capital gain in a share exchange. It will retain the basis of taxability on the basis of new shares.

8.5.3. Other Activities of the European Union

Multilateral Agreement

The Arbitration Convention⁷⁶

⁷⁵ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

⁷⁶ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

This permits the member states within the union to resolve the disputes arising amongst the member states on account of transfer pricing issues. The Convention has adopted the arm's length principle contained under the OECD MC Article 7(2) and Article 9.

*Undertakings for Collective Investment in Transferable Securities (UCITS)*⁷⁷

These are in the nature of collective open ended investment funds. If a member state meets the UCITS criteria, funds can be freely marketed in other European Union countries.

*Mutual Assistance Directive*⁷⁸

This directive has been formed to deal with the exchange of information which would assist in assessment of tax on income, capital and VAT.

*European Human Rights Convention*⁷⁹

The European Convention on Human Rights (ECHR) (formally the Convention for the Protection of Human Rights and Fundamental Freedoms) is an international treaty to protect human rights and fundamental freedoms in Europe. Drafted in 1950 by the then newly formed Council of Europe, the convention was entered into force on 3 September 1953. All Council of Europe member states are party to the Convention and new members are expected to ratify the convention at the earliest opportunity.

The Convention established the European Court of Human Rights (ECTHR). Any person who feels his or her rights have been violated under the Convention by a state party can take a case to the Court. Judgments finding violations are binding on the States concerned and they are obliged to execute them. The Committee of Ministers of the Council of Europe monitors the execution of judgements, particularly to ensure payment of the amounts awarded by the Court to the applicants in compensation for the damage they have sustained. The establishment of a Court to protect individuals from human rights violations is an innovative feature for an international convention on human rights, as it gives the individual an active role on the international arena (traditionally, only states are considered actors in international law). The European Convention is still the only international human rights agreement providing such a high degree of individual protection. State parties can also take cases against other state parties to the Court, although this power is seldom used.

⁷⁷ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

⁷⁸ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

⁷⁹ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

9. Harmful Tax Competition

9.1 Introduction

Strategies adopted by taxpayers to reduce their tax bills through tax evasion or tax avoidance are frowned upon by the countries globally. These strategies exploit the gaps prevailing in the existing taxation system of a country. Such strategies enable tax arbitrage to those who can use the resources and save on their taxes. Various attempts have been made across the globe to curb such harmful tax competition. The latest attack on strategic tax arbitrage strategies is the 15 Action Plans of the G20 OECD BEPS project. It provides that the practice of shifting profits in low tax countries or tax havens without any real economic activities deprives the country which is entitled to its fair share of tax revenue especially the emerging economies (e.g. The BRICS Economies⁸⁰).

9.2 OECD Initiative on Harmful Tax Competition⁸¹

9.2.1. Harmful Tax Competition and BEPS Action Plans

The initiative to counter harmful tax competition was undertaken by OECD in the year 1998. This initiative was sought to ensure that countries get their fair share of tax revenues. In the present scenario, the same continues to hold significance. Executive summary of the Action Plan 5 provides as under –

“Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework”.

9.2.2. “Harmful Tax Competition: An Emerging Global Issue” by the Organisation for Economic Co-operation and Development (OECD) – year 1998

In the report, the OECD had grouped the countries in three categories viz. member country preferential regimes, tax havens, and non-member economies. It established criteria for identifying each category. Tax havens are characterised by having only nominal or no taxes, impeding the free exchange of information on taxpayers with other governments through administrative practices or laws, non-transparency, and a lack of substantial economic activities. Harmful preferential regimes (member or non-member countries) were identified by some traits. Like tax havens, their legal or administrative systems hamper the exchange of information and create an absence of transparency and have effectively low or no taxes. Finally, the regime may partially isolate itself from

⁸⁰ Brazil, Russia, India, China, South Africa

⁸¹ Basic International Taxation – Second Edition – Volume I : Principles by Professor Roy Rohatgi published by Taxmann Allied Services Pvt. Ltd.

the taxpayers and bear little to none of the tax burden, a practice known as “ring-fencing”.

OECD provides that such practices among the nations is largely for attracting geographical mobile activities such as financial and other services⁸², including provision of intangibles. The report however, provided that the report does not apply to activities which are carried out to attract foreign direct investments or the competition to attract passive, portfolio investment. The report raises concerns that the activities are eroding the legitimate and fair share of other countries.

Based on its observations, the OECD had provided various recommendations which are as follows –

- Wide application of the controlled foreign corporation rules;
- Rationalise the participation exemption and foreign sourced income;
- Extensive use of exchange of information instrument;
- Suitable terms which discourages ‘treaty shopping practices’ by invoking ‘*limitation of benefits, general anti-avoidance rules, beneficial ownership*’, etc. and other similar related concepts;
- Avoid entering into tax treaties with tax havens (e.g. Cayman Islands, British Virgin Islands, Gibraltar, etc);
- Blacklisting of a few countries by regarding them as countries resorting to harmful tax practices;
- Countries should be careful while transacting with a country having high banking secrecy norms.

The above initiative had significant impact in financial sectors in jurisdictions which were classified as tax havens. Most of these jurisdictions restructured their regulations to meet the OECD standards. Along with the BEPS project and various other anti-avoidance measures, one can expect a tax regime where there will be more contribution to national GDP of each country specifically in the form of taxes.

9.3 Action Plans to Counter Base Erosion and Profit Shifting

9.3.1. Background on BEPS

Base erosion and profit shifting (BEPS) is a global problem which requires global solution. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. BEPS is of major significance for developing countries due to their heavy reliance on corporate

⁸² Centralized operations of multinational activities

income tax, particularly from multinational enterprises (MNEs).

In an increasingly interconnected world, national tax laws have not always kept pace with tax planning by global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps that can be exploited to generate double non-taxation or reduced taxation. This undermines the fairness and integrity of tax systems.

This increased attention and the inherent challenge of dealing comprehensively with such a complex subject has encouraged a perception that the domestic and international rules on the taxation of cross-border profits are now broken and that taxes are only paid by the naive. MNEs are being accused of dodging taxes worldwide and in particular in developing countries, where tax revenue is critical to foster long term development.

Business leaders often argue that they have a responsibility towards their shareholders to legally reduce the taxes their companies pay. Some of them might consider most of the accusations unjustified, in some cases deeming governments responsible for incoherent tax policies and for designing tax systems that provide incentives for BEPS. They also point out that MNEs are still sometimes faced with double taxation on their profits from cross-border activities, with mutual agreement procedures sometimes unable to resolve disputes among governments in a timely manner or at all.

The debate over BEPS has also reached the political level and has become an issue on the agenda of several OECD and non-OECD countries. The G20 leaders meeting in Mexico on 18-19 June 2012 explicitly referred to “the need to prevent base erosion and profit shifting” in their final Declaration. This message was reiterated at the G20 finance ministers meeting of 5-6 November 2012, in the final communiqué.

The European Commission presented an Action Plan on 17 June 2015 to fundamentally reform corporate taxation in the EU. The Action Plan sets out a series of initiatives to tackle tax avoidance, secure sustainable revenues and strengthen the Single Market for businesses.

9.3.2. Legality and issues relating to BEPS

Corporate tax is levied at a domestic level. When MNEs undertake activities cross border, the interaction of domestic tax systems means that an item of income can be taxed by more than one jurisdiction, thus resulting in double taxation. The interaction can also leave gaps, which result in income not being taxed anywhere. BEPS strategies take advantage of these gaps between tax systems in order to achieve double non-taxation or very low taxation.

Although some schemes used are illegal, most are not. Largely they just take advantage of current rules that are still grounded in a bricks and mortar economic environment rather than today’s environment of global players which is characterised by the increasing importance of digital economy, e-commerce, intangibles and risk management.

A question arises for consideration: if the BEPS strategies/schemes are considered to be legal, then why should anyone worry about BEPS. There are three important factors in this regard. First, because it distorts competition: businesses that operate cross-border may profit from BEPS opportunities, giving them a competitive advantage over enterprises that operate at the domestic level. Second, it may lead to inefficient allocation of resources by distorting investment decisions towards activities that have lower pre-tax rates of return, but higher after-tax returns. Finally, it is an issue of fairness: when taxpayers (including ordinary individuals) see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers.

9.3.3. Importance of BEPS Project now and OECD's role in addressing BEPS

The OECD has been providing solutions to tackle aggressive tax planning over the years. The debate and concern over BEPS is now at the highest political levels in many OECD and non-OECD countries. Apart from some cases of very bad and easily noticed abuses, the issue lies with the tax rules themselves. Business cannot be faulted for making use of the rules that governments have put in place. It is therefore governments' responsibility to revise the rules or introduce new rules⁸³.

Many BEPS strategies take advantage of the interaction between the tax rules of different countries, which means that unilateral action by individual countries will not fully address the problem. In addition, unilateral and uncoordinated actions by governments responding in isolation could result in double – and possibly multiple – taxation for business. This would have a negative impact on flow of capital and technology, investment, growth and employment globally. There is therefore a need to provide an internationally coordinated approach which will facilitate and reinforce domestic actions to protect tax bases and provide comprehensive international solutions to respond to the issue. The BEPS Actions provides consensus-based plans to address these issues and is part of the OECD's ongoing efforts to ensure that the global tax architecture is equitable and fair.

9.3.4. BEPS Action Plans

Developed in the context of the OECD/G20 BEPS Project, the 15 actions equip governments with domestic and international instruments to address tax avoidance, to ensure profits are taxed where economic activities generating the profits are performed and where value is created. The 15 Action Plans (i.e., BEPS 1.0) set forth to address BEPS in a comprehensive and coordinated manner. These actions will result in fundamental changes to the international tax standards and are based on three core principles: coherence, substance, and transparency. Looking towards innovative approaches to deliver change quickly, the Action Plans calls for a multilateral instrument that countries can use to implement the measures developed in the course of the work. While the OECD steps up its efforts to address double non-taxation, it will also continue

⁸³ <https://www.oecd.org/ctp/BEPS-FAQsEnglish.pdf>

work to eliminate double taxation, through increased efficiency of mutual agreement procedures and arbitration provisions.

In July 2013, the Action Plan on BEPS directed the OECD to commence work on 15 actions designed to ensure the coherence of corporate income taxation at the international level, which were finalised and issued in October, 2015. Pursuant to the issuance of the reports in October 2015, there has been continuous work in this regard resulting in actions both through unilateral and multilateral mechanisms for adopting and implementing the recommendations of the Action Plans.

Followed by the aforementioned 15 Action Plans, the OECD also launched BEPS 2.0 to address the tax challenges arising from the current age of digitalisation of the economy.

9.3.5. Actions Plans being carried out in the context of BEPS

Domestic tax systems are coherent – tax deductible payments by one person results in income inclusions by the recipient. We need international coherence in corporate income taxation to complement the standards that prevent double taxation with a new set of standards designed to avoid double non-taxation. Four actions in the BEPS Action Plan (Actions 2, 3, 4, and 5) focus on establishing this coherence.

Current rules work well in many cases, but must be modified to prevent instances of BEPS. The involvement of third countries in the bilateral framework established by treaty partners puts a strain on the existing rules, in particular when done via shell companies that have little or no economic substance: e.g. office space, tangible assets, business operations and employees. In the area of transfer pricing, rather than replacing the current system, the best course is to fix the flaws in it, in particular with respect to returns related to over-capitalisation, risk and intangible assets. Nevertheless, special rules, either within or beyond the arm's length principle, may be required with respect to these flaws. Five actions in the BEPS Action Plan focus on aligning taxing rights with substance (Actions 6, 7, 8, 9, and 10).

Because preventing BEPS requires greater transparency at many levels, the Action Plans calls for: improved data collection and analysis regarding the impact of BEPS; taxpayers' disclosure about their tax planning strategies; and less burdensome and more targeted transfer pricing documentation. Four actions in the BEPS Action Plan focus on improving transparency (actions 11, 12, 13, and 14).

9.3.6. Implementation of the BEPS Actions

The BEPS Action Plans calls for the development of tools that countries can use to shape fair, effective and efficient tax systems. As BEPS strategies often rely on the interaction of countries' different domestic law/tax systems, these tools will have to address the gaps and frictions that arise from the interaction of these systems. These may be in the form of:

- Changes to the OECD Model Tax Convention which will result in changes that are directly effective;
- Others will be implemented by countries through their domestic law, bilateral treaties or a multilateral instrument.

In light of this, the OECD Model Tax Convention has been updated (2017 update) incorporating the treaty-related measures suggested by the BEPS Action Plans. Further, the domestic tax laws and bilateral tax treaties of countries are currently being amended in line with the BEPS Action Plans. The multilateral instrument ('MLI') known as "*Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting*" is a document to ensure implementation of recommendations of BEPS Action Plans (refer details in point 7.2.4 above). MLI works as a guide for jurisdictions to choose from the given recommendations and also to mandate compliance with minimum standards. It applies only in those tax treaties where both the countries have conveyed their intention to include the other country to be covered by the MLI.

9.3.7. Time frame for Action Plans

Addressing BEPS is critical for most countries and must be done in a timely manner so that concrete actions can be delivered quickly before the existing consensus-based framework unravels. At the same time, governments need time to complete the necessary technical work and achieve widespread consensus.

9.3.8. Role of the G20 in BEPS Project

Since its launch by the OECD, the work on BEPS received strong and consistent support by the G20 and it has been a key item on the Finance Ministers' and Leaders' agendas. Furthermore, all G20 countries have participated as equal partners in the development of the work. Their continued participation and endorsement at the highest levels of government have been critical to guarantee a level playing field and prevent inconsistent standards.

The delivery of the 2014 BEPS output is concrete evidence of how OECD and G20 members working together can achieve consensus on important tax reforms with a worldwide impact. Non-OECD G20 countries are Associates in the BEPS Project and participate on an equal footing in the decision making process, at the level of both the OECD Committee on Fiscal Affairs and of its subsidiary bodies carrying out the technical work. In addition, other countries and stakeholders have been engaged in regular and fruitful dialogues throughout this process. In response to the G20's call for broad and consistent implementation of the BEPS package, the Inclusive Framework was established

in June 2016 at Kyoto which now has around 143⁸⁴ countries as members.

9.3.9. BEPS Action Plan and Tax Competition

Taxation is at the core of countries' sovereignty, and each country is free to set up its corporate tax system as it chooses, which includes charging of the tax rate of its choice. The work is not aimed at restricting the sovereignty of countries over their own taxes; instead, it is aimed at restoring and strengthening sovereign taxing rights by ensuring that countries can protect their tax bases. It does so by addressing regimes that apply to mobile activities and that unfairly erode the tax bases of other countries which potentially distort the location of capital and services.

9.3.10. Risk of not addressing harmful tax practices

The dangers of not addressing harmful tax practices are being felt both by governments and business. Firstly, harmful tax competition can introduce distortions and an unequal level playing field between businesses operating at domestic level and those that operate globally and have access to preferential tax regimes. Secondly, countries have long recognised that a “race to the bottom” would ultimately drive applicable tax rates on certain sources of income to zero for all countries, whether or not this is the tax policy a country wishes to pursue.

9.3.11. BEPS Action Plan & “tax havens”

The BEPS Action Plan aims to end the use of shell companies used to stash profits offshore or unduly claim tax treaty protection and neutralise all schemes that artificially shift profits offshore. Though the BEPS Action Plan is not about dictating whether countries should have a specific corporate income tax rate, it will have an impact on regimes that seek to attract foreign investors without requiring that they have any economic substance in those countries.

9.3.12. Is BEPS effectively a tax increase on multinationals?

The BEPS project is not about increasing corporate taxes. Non-taxation or low-taxation is not itself the concern, but it becomes so when it is achieved through practices that artificially separate taxable income from the activities that generate it. These strategies may increase tax disputes as countries fight against tax strategies that defy common sense. Implementation of the recommendations coming out of the BEPS project will reduce those disputes, giving business greater certainty and reinforcing the fairness and consistency of international tax system.

⁸⁴ Updated as on 9 June 2023. Refer <https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf>

9.3.13. Brief description, timeline and present status of the BEPS Action Plans⁸⁵

In light of above, the 15 Action Plans addressed by the BEPS project are briefly discussed herein below:

Action 1 – Addressing the tax challenges of the digital economy

Description of tasks and issues:

BEPS Action Plan 1 deals with the tax challenges of the Digital Economy. The digital economy is the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardized, improving business processes and bolstering innovation across all sectors of the economy. The tasks assigned under this Action Plan is to identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.

Issues to be examined include, but are not limited to, the ability of an enterprise to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterization of income derived from new business models, the application of related source rules, and how to ensure effective collection of Value Added Tax/Goods and Services Tax with respect to the cross-border supply of digital goods and services.

The 2015 report on this Action Plan developed alternative options viz. (1) significant economic presence nexus (nexus would be established where a non-resident has a significant economic presence evidenced by factors such as revenue from remote transactions, local domain names, localized websites, local currency payment options, number of active users in a country, online contracting and data collection); (2) withholding taxes on digital income from goods or services ordered online (tax could be a final tax or as a back-up measure to enforce net-basis taxation); and (3) 'equalization levy' (tax to equalize the tax burden on remote and domestic suppliers of similar goods and services, similar to an insurance excise taxes imposed upon foreign insurers). These measures could be imposed through domestic legislation and are not recommended as an international standard. However, the report states that countries may wish to impose these measures to address Digital Economy BEPS concerns that those countries believe are not adequately addressed by the OECD's recommendations, or as a 'stop-gap' measure until the OECD's recommendations are fully implemented. To carry out the work given under this Action Plan, a Task Force on Digital Economy ('TFDE') was established which was mandated with a task to present an interim report

⁸⁵<http://www.oecd.org/ctp/beeps-reports-2015-executive-summaries.pdf> and further updates

by the end of 2018 and come up with the final recommendations by the end of 2020. India is one of the participant countries of the TFDE. The TFDE released the said interim report on 16th March 2018 titled “*Tax Challenges Arising from Digitalisation - Interim Report 2018*”. The Interim Report sets out the BEPS inclusive framework’s agreed direction of work on digitalization and the international tax rules through 2020 and inter alia includes:

- In-depth analysis of value creation across different digitalised business models, focusing on the main characteristics of digital markets and processes of value creation;
- Specific measures relevant to digitalisation and the resulting impact on the behavior of highly digitalised business;
- Overview of recent tax policy developments that are potentially relevant to digitization, focusing on measures enacted to address the broader tax challenges identified in 2015 report (*supra*);
- The description of the challenges identified with respect to the continuing effectiveness of international tax standards in light of the issues raised by digitalization of the economy;
- The need for interim measures to be introduced by countries
- How digitalization is changing other parts of the tax systems, providing new opportunities and risks for policymakers and tax administrators;

In line with this Action Plan, India has taken the following steps under its domestic tax laws:

- Introduced vide Finance Act, 2016, chapter VII on equalization levy which is a self-contained code to tax digital ecommerce transactions⁸⁶
- Introduced the concept of significant economic presence vide Finance Act 2018⁸⁷, explanation 2A to section 9(1)(i).⁸⁸
- Scope of Equalization Levy is expanded by Finance Act 2020 to include levy of 2 percent on consideration received or receivable by an ‘*e-commerce operator*’ from ‘*e-commerce supply or services*’ to certain ‘*specified persons*’

⁸⁶The provisions of equalization levy were made effective from 1 June 2016

⁸⁷ Explanation 2A inserted by Finance Act 2018 is replaced by Finance Act 2020 and is applicable from 1 April 2022. Rule 11UD prescribes the thresholds for the purposes of significant economic presence

⁸⁸For further details refer Module A paragraph 4.4.2

Proposed Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy

The OECD/G20 Inclusive Framework on BEPS, has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. A historic milestone was reached at the 15th Plenary Meeting of the OECD/ G20 Inclusive Framework on BEPS on 11 July 2023 as 138 members of the Inclusive Framework approved an Outcome Statement on the Two-Pillar Solution to address the tax challenges arising from the digitalisation of the economy.

The aim of **Pillar One** is to reach a global agreement on adapting the allocation of taxing rights on business profits in a way that expands the taxing rights of market jurisdictions. Pillar One seeks to adapt the international corporate tax system to the digital age through significant changes to the rules applicable to business profits to ensure that the allocation of taxing rights on business profits is no longer exclusively determined by reference to physical presence. It intends to expand the taxing rights of market jurisdictions (which, for some business models, is the jurisdiction where the user is located) where there is a significant and sustained participation of a business in the economy of that jurisdiction, either physically or remotely. It also aims to improve tax certainty by introducing improved dispute prevention and resolution mechanisms.

Pillar 1 seeks to remunerate the market jurisdictions through the following:

- **Amount A:** Allocation of non-routine profits of the multi-national enterprises ('MNE') to market jurisdictions using a formulary approach. Amount A applies to MNEs with Revenues exceeding EUR 20 billion and a profitability greater than 10%. It reallocates 25% of the MNE's profit in excess of 10% of its Revenues to market jurisdictions in which the MNE satisfies the quantitative nexus test, subject to adjustments under the marketing and distribution profits safe harbour. These profits will be allocated in proportion to the amount of Revenues the MNE derives from those jurisdictions as determined under specific revenue sourcing rules. Because Amount A rules will apply as an overlay to the existing profit allocation rules, it includes a mechanism to reconcile the respective different profit allocation systems and prevent double taxation. The functioning of these rules is further illustrated in the process map below.
- **Amount B:** Fixed remuneration based on arm's length price for defined baseline and marketing functions that take place in the market jurisdiction. Amount B simplifies the existing transfer pricing rules for all taxpayers. It is focused on the application of transfer pricing rules to so called baseline marketing and distribution activities, likely the most frequent fact patterns that MNEs encounter in the jurisdictions where they operate. Reports from some low-capacity jurisdictions estimate that transfer pricing disputes relating to distribution activities represent between 30% and 70% of all of their transfer pricing disputes. Amount B is intended to increase tax certainty, reduce compliance and administrative costs and in particular assist low-capacity jurisdictions that often suffer

from the absence of local market comparables.

- **Amount C:** The return under Amount C covers any additional profits where in-country functions exceed the baseline activities (compensated under Amount B).

While Amount A seeks to create a new taxing right for the market jurisdictions, Amount B and C would be based on the existing profit allocation rules (including the reliance on physical presence) with improved practical application of the arm's length principles.

Whereas Pillar Two seeks to achieve development of global minimum tax rules with the objective of ensuring that global business income is subject to at least 15% tax regardless of where they are headquartered or the jurisdictions, they operate in. The Global Anti-Base Erosion Model Rules (also called the GLOBE rules) were approved by the Inclusive Framework in March, 2022. As per the OECD Report 2023, around 50 jurisdictions have taken necessary steps to implement the global minimum tax (GMT). It is projected that by 2025, approximately 90% of the global MNEs with revenue of above Euro750m will be subject to a minimum effective tax rate of 15% in every jurisdiction in which they operate as the implementation of the GMT continues to gain momentum.

Adoption of Pillar Two by countries

Around 140 countries have announced their intent to adopt Pillar Two; however, their timelines for implementation may vary. Action points agreed upon by some of the Asian countries for adopting Pillar Two and GMT are provided below:

- Japan has enacted Pillar Two Income Inclusion Rule (IIR) regulations beginning from 1 April 2024.
- South Korea became the first nation to adopt new GMT regulations in December 2022 which complied with Pillar Two of the OECD. The Adjustment of International Taxes Act (AITA), which contains the new regulations, will be effective from 1 January 2025 (instead of 1 January 2024, as originally planned).
- Vietnam plans to begin applying Pillar Two regulations beginning from 1 January 2024.
- China has long pushed for implementation of digital taxes' on the profits of large technology companies. China participated in the development of BEPS Pillar One and Pillar Two but has not formally indicated its intentions of implementing Pillar Two rules at the local level.
- India, as a member of the Inclusive Framework on BEPS, is closely following and actively participating in international negotiations on Pillar Two. However, it is yet to introduce any specific amendments in the domestic law related to Pillar Two.

Action 2 – Neutralising the effects of hybrid mismatch arrangements

Description of tasks and issues:

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness. With a view to increasing the coherence of corporate income taxation at the international level, the OECD/G20 BEPS Project called for recommendations regarding the design of domestic rules and the development of model treaty provisions that would neutralise the tax effects of hybrid mismatch arrangements. The report has set out recommendations. Part I contains recommendations for changes to domestic law and Part II sets out recommended changes to the OECD Model Tax Convention. Once translated into domestic and treaty law, these recommendations will neutralise hybrid mismatches, by putting an end to multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid. By neutralising the mismatch in tax outcomes, the rules will prevent these arrangements from being used as a tool for BEPS without adversely impacting cross-border trade and investment. With an intention to implement treaty-related measures under this Action Plan, Part II of the MLI deals with Hybrid Mismatches under Article 3 which covers transparent entities. With respect to transparent entities, the article ensures that tax treaty benefits are granted only in appropriate cases and also that the benefits of the treaty are denied where neither Contracting State treats, under its domestic law, the income of the entity as the income of its residents.

The OECD on 27 July 2017 released a final report on branch mismatch structures titled *Neutralising the Effects of Branch Mismatch Arrangements* which sets out recommendations for branch mismatch rules in order to bring the treatment of these structures in line with the treatment of hybrid mismatch as per Action Plan 2. Branch mismatches arise where the ordinary rules for allocating income and expenditure between the branch and head office result in a portion of the net income of the taxpayer escaping the charge to taxation in both the Contracting States i.e. at branch and residence jurisdiction respectively. Unlike hybrid mismatches which result from conflicts in the legal treatment of entities or instruments, branch mismatches are the result of differences in the way the branch and head office account for a payment made between them. This report includes specific recommendations for improvements to domestic law intended to reduce the frequency of branch mismatches as well as targeted branch mismatch rules which adjust the tax consequences in either the residence or branch jurisdiction in order to neutralise the hybrid mismatch without disturbing any of the other tax, commercial or regulatory outcomes.

Action 3 – Designing effective Controlled Foreign Company (CFC) Rules

Description of tasks and issues:

Controlled foreign company (CFC) rules respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation. At the time when the Final BEPS report was released in October 2015, 30 of the countries participating in the OECD/G20 BEPS Project already had CFC rules, and many others had expressed interest in implementing them. However, existing CFC rules have often not kept pace with changes in the international business environment, and many of them have design features that do not tackle BEPS effectively. In response to the challenges faced by existing CFC rules, the Action Plan on BEPS recommended actions regarding the design of CFC rules. Significant work was not done in the past in this area. The report recognises that by working together countries can address concerns about competitiveness and level the playing field. The report sets out recommendations in the form of building blocks. These recommendations are not minimum standards, but they are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries. The report has set out six building blocks for the design of effective CFC rules. The same are as follows –

- (i) Definition of CFC
- (ii) CFC exemptions and threshold requirements
- (iii) Definition of income
- (iv) Computation of income
- (v) Attribution of income
- (vi) Prevention and elimination of double taxation

Each country prioritises policy objectives differently. The recommendations provide flexibility to implement CFC rules that combat BEPS in a manner consistent with the policy objectives of the overall tax system and the international legal obligations of the country concerned. The report recognises that the recommendations must be sufficiently adaptable to comply with EU law and it sets out possible design options that could be implemented by EU Member States. Once implemented, the recommendations will ensure that countries will have effective CFC rules that address BEPS concerns.

Even though India do not have specific CFC rules under its domestic tax laws, subsequent to the BEPS project, India has introduced the concept of place of effective management (POEM) [under section 6(3) of the Act w.e.f. 1 April 2016] for the purpose of determining tax residency of foreign companies in India. Even though the residence

through POEM is different from CFC rules, it has a similar effect by bringing to tax income of overseas companies.

Action 4 – Limiting base erosion involving interest deductions and other financial payments

Description of tasks and issues:

It is an empirical matter of fact that money is mobile and fungible. Multinational groups achieve favourable tax results by adjusting the amount of debt in a group entity. The influence of tax rules on the location of debt within multinational groups has been established in a number of academic studies and it is well known that groups can easily multiply the level of debt at the level of individual group entities via intra-group financing. Financial instruments which are economically equivalent to interest having different legal form, escape the restrictions on interest deductibility. To address these risks, the report analyses several best practices and recommends an approach which directly addresses the risks. The recommended approach is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). As a minimum this should apply to entities in multinational groups. To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognising that not all countries are in the same position, the recommended approach includes a corridor of possible ratios of between 10% and 30%. The report also includes factors which countries should take into account in setting their fixed ratio within this corridor. The approach can be supplemented by a worldwide group ratio rule which allows an entity to exceed this limit in certain circumstances. Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach proposes a group ratio rule alongside the fixed ratio rule. This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. In order to provide further guidance on the design and operation of the group ratio rule, OECD released an updated version of this Action Plan on 22 December 2016.

The earnings-based worldwide group ratio rule can also be replaced by different group ratio rules, such as the "equity escape" rule (which compares an entity's level of equity and assets to those held by its group) currently in place in some countries. A country may also choose not to introduce any group ratio rule. In such a case, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination. The recommended approach will mainly impact entities with both a high level of net interest expense and a high net interest/EBITDA ratio, in particular where the entity's ratio is higher than that of its worldwide group. This is a straightforward approach and ensures that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities. An important feature of the fixed ratio rule is that it only limits an entity's net interest deductions (i.e. interest expense in

excess of interest income). The rule does not restrict the ability of multinational groups to raise third party debt centrally in the country and entity which is most efficient taking into account non-tax factors such as credit rating, currency and access to capital markets, and then on-lend the borrowed funds within the group to where it is used to fund the group's economic activities.

The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk, such as: i) *ade minimis* threshold which carves-out entities which have a low level of net; ii) An exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, subject to conditions; and iii) The carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years.

The amount of intragroup interest and payments economically equivalent to interest is also affected by transfer pricing rules which is also addressed in the OECD Report Aligning Transfer Pricing Outcomes with Value Creation (Action Plan 8-10), thereby limiting the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided and require group synergies to be taken into account when evaluating intragroup financial payments.

On account of specific features of banking and insurance sectors, the OECD in its updated version of this Action Plan released on 22nd December 2016 (*supra*) has provided with the approaches to deal with risks posed by these sectors.

A coordinated implementation of the recommended approach will successfully impact on the ability of multinational groups to use debt to achieve BEPS outcomes. To ensure the recommended approach remains effective in tackling BEPS involving interest, the implementation, operation and impact of the approach will be monitored over time, to allow for a comprehensive and informed review as necessary.

Based on these recommendations, India has introduced section 94B vide Finance Act, 2017 under its domestic tax laws. The provision limits the interest deductions claimed by an entity against the loan provided by its associated enterprise to 30% of its EBITDA or interest paid or payable to associated enterprises, whichever is less. This provision aims to curb the erosion of tax base by cross-border profit shifting through excessive interest payments. Further, in line with the recommendations, this provision also provides a carry forward of the unutilized portion of the interest cost to eight subsequent year.

Action 5 - Countering harmful tax practices more effectively, taking into account transparency and substance

Description of tasks and issues:

More than 15 years have passed since the publication of the OECD 1998 Report *“Harmful Tax Competition: An Emerging Global Issue”* and the underlying policy concerns expressed then are as relevant today as they were then. Current concerns are primarily about preferential regimes that risk being used for artificial profit shifting and about a lack of transparency in connection with certain rulings. In January 2019, the OECD released Harmful Tax Practices - 2018 Progress Report on Preferential Regimes, approved by the OECD/G20 Inclusive Framework on BEPS. The Progress Report includes the results of the review of preferential tax regimes, which has been undertaken by the Forum on Harmful Tax Practices (FHTP) since the start of the BEPS Project in accordance with the BEPS Action 5 minimum standard.⁸⁹

The continued importance of the work on harmful tax practices was highlighted by the inclusion of this work in the Action Plan on Base Erosion and Profit Shifting, whose Action 5 committed the FHTP to:

“Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework”. The elements of a strategy to engage with countries other than OECD Members and BEPS Associates in order to achieve a level playing field and avoid the risk that the work on harmful tax practices could displace regimes to third countries is outlined in the Report, together with the status of discussions on the revisions or additions to the existing framework.”

The main focus of the FHTP’s work has been on agreeing and applying a methodology to define the substantial activity requirement to assess preferential regimes, looking first at intellectual property (IP) regimes and then other preferential regimes. In this regard, this Action Plan has reached a developed the “nexus approach” to determine the substantial activity requirement. This approach was developed in the context of IP regimes, and it allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development expenditures that gave rise to the IP income. The report also focuses on improving transparency through a

⁸⁹ “Action 5 Harmful Tax Practices”, The OECD, <https://www.oecd.org/tax/beps/beps-actions/action5> (accessed in December 2023)

framework which covers six categories of rulings⁹⁰ that could give rise to BEPS concerns in the absence of compulsory spontaneous exchange.

These aspects of the work will be taken forward in the context of the wider objective of designing a more inclusive framework to support and monitor the implementation of the BEPS measures. An ongoing monitoring and review mechanism covering preferential regimes, including IP regimes, and the transparency framework has been agreed and will now be put in place.

On 16 October 2017, the OECD released a report titled “*Harmful Tax Practices - 2017 Progress Report on Preferential Regimes*”, approved by the inclusive framework on BEPS. This document combines all aspects of the work of the FHTP on preferential regimes since the release of this Action Plan. The progress report includes the results of the review of preferential tax regimes, which has been undertaken by the FHTP in accordance with the minimum standard of this Action Plan. The report includes four annexes:

1. Timelines for implementing the nexus approach for IP regimes;
2. Guidance on closing off of regimes and grandfathering for non-IP regimes;
3. Monitoring data on preferential regimes; and
4. Substantial activities in non-IP regimes.

The FHTP will continue its work, including to monitor and review preferential tax regimes which are being amended to conform to this Action Plan.

On 4 December 2017 the OECD released peer review reports on exchange or information on tax rulings titled “*Harmful Tax Practices-Peer Review Reports on the Exchange of Information on Tax Rulings*”. This report reflects the outcome of the first peer review of the implementation of the minimum standard of this Action Plan. It covers the jurisdictions which participated in the BEPS Project prior to the creation of the inclusive framework, and it assesses implementation for the *1 January 2016 – 31 December 2016* period.

The 2018 Progress Report on Preferential Regimes examined the non-IP regimes in India viz. (a) Deductions in respect of certain incomes of offshore banking units and international financial services centre; (b) Special provisions in respect of newly established units in special economic zones; (c) Special provisions relating to income of shipping companies – tonnage tax scheme; and (d) Taxation of profit and gains of life

⁹⁰Six categories of rulings: (i) rulings related to preferential regimes; (ii) cross border unilateral advance pricing arrangements or other unilateral transfer pricing rulings; (iii) rulings giving a downward adjustment to profits; (iv) permanent establishment (PE) rulings; (v) conduit rulings; and (vi) any other type of ruling where the FHTP agrees in the future that the absence of exchange would give rise to BEPS concerns.

insurance business and found that all the four tax regimes were not harmful. As for IP regimes, the Report found India's Tax on income from patent met the substance requirement (nexus approach) to be in place and was not harmful.

Since the beginning of the BEPS Action 5 peer reviews, the FHTP has reviewed close to 320 preferential regimes and the substance legislation of 12 'no tax' or 'only nominal tax' jurisdictions. In June 2023, the FHTP released the results for a further five preferential tax regimes and has launched its third annual monitoring of the effectiveness in practice of the substantial activities requirements in no or only nominal tax jurisdictions, with results to be expected later this year⁹¹.

In addition, almost 50,000 exchanges of information on tax rulings between governments have taken place to date, with peer reviews on tax rulings covering 131 jurisdictions.

In order to implement the recommendations made under this Action Plan to bring transparency in cross border transactions⁹², amendments were made to Rule 44E⁹³, Form 34C, Form 34D and Form 34DA under the Income-tax Act, 1961.

Action 6 – Preventing the granting of treaty benefits in inappropriate circumstances

Description of tasks and issues:

Action 6 of the OECD/G20 BEPS Project identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving countries of tax revenues. Countries have therefore agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping. They also agree that some flexibility in the implementation of the minimum standard is required as these provisions need to be adapted to each country's specificities and to the circumstances of the negotiation of bilateral conventions.

New treaty anti-abuse rules first address treaty shopping, which involves strategies through which a person who is not a resident of a State attempts to obtain benefits that a tax treaty concluded by that State grants to residents of that State, for example by establishing a letterbox company in that State. The following approach is recommended to deal with these strategies:

- First, a clear statement that the States that enter into a tax treaty intend to avoid

⁹¹ OECD Secretary - General Tax Report to 20 Leaders, India, September 2023

⁹²Under this Action Plan, exchange of PE rulings (by Authority for Advance Rulings) are required to be done not only with the countries of residence of all related parties with whom taxpayer enters into transaction but also with the country of residence of the immediate parent company and the ultimate parent company

⁹³Rule 44E – Application of obtaining an advance ruling and related forms

creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, also including through treaty shopping arrangements will be included in tax treaties.

- Second, a specific anti-abuse rule, the limitation-on-benefits (LOB) rule that limits the availability of treaty benefits to entities that meet certain conditions will be included in the treaties. These conditions, which are based on the legal nature, ownership in, and general activities of the entity, seek to ensure that there is a sufficient link between the entity and its State of residence. Such LOB provisions are currently found in treaties concluded by a few countries and have proven to be effective in preventing many forms of treaty shopping strategies.
- Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the LOB rule described above, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or “PPT” rule) will be included in the treaties. Under that rule, if one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.

As per Paragraph 12 of the final report on this Action Plan additional work was to be carried on with respect to pension funds. Accordingly, in February 2016 the OECD released a discussion draft on treaty residence of pension funds wherein it included draft changes to Articles 3 and 4 of OECD MTC in order to ensure that pension fund is considered to be a resident of the State in which it is constituted for the purposes of tax treaties. Further, paragraph 14 of the final report on this Action Plan had indicated that the OECD will continue to examine issues related to the treaty entitlement of non-CIV funds in order to ensure that the new treaty provisions included in this Action Plan address adequately the treaty entitlement of these funds. In March 2016 the OECD has released a consultation document on treaty entitlement of non-CIV funds. On 29 May 2017 the OECD released the key document which will form the basis of the peer review of the Action 6 minimum standard on preventing the granting of treaty benefits in inappropriate circumstances. The document includes the terms of reference which sets out the criteria for assessing the implementation of the minimum standard of this Action Plan, and the methodology which sets out the procedural mechanism by which the review will be conducted.

The three minimum standards mentioned above recommended by this Action plan have been incorporated in the latest update of the OECD MTC (2017 update) and in the Multilateral Instrument. Further, the change made in paragraph 3 of Article 4 (tie-breaker rule for dual-residents) to the OECD MTC and inclusion of Article 4 in the MLI is an outcome of the suggestions made under BEPS Action Plan 6 in this regard.

The Fifth Peer Review Report on Treaty Shopping, which was published in March 2023, revealed ongoing progress in the enforcement of the BEPS Action 6 minimum standard, aimed at preventing tax treaty abuse. The sixth peer review process initiated in April 2023 is currently in progress. The majority of Inclusive Framework members continue to utilise the BEPS MLI as the means to implement Action 6.

As of 1 September 2023, the BEPS MLI has already made modifications to approximately 1,200 bilateral tax treaties which were entered into by 83 jurisdictions which have ratified it. Additionally, approximately 650 more tax treaties are poised for modification once all signatories have ratified the BEPS MLI.

India has modified several of its tax treaties through the MLI to include provisions such as the PPT and LOB. As on 30 November 2022, 53 tax treaty partners, namely, Japan, Malaysia, China, Singapore etc. have deposited their instruments for ratification. Accordingly, MLI is effective or is going to be effective soon in relation to the tax treaties signed by India with these 53 countries.

Action 7 – Preventing the artificial avoidance of PE status

Description of tasks and issues:

Changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions have been recommended.

The changes to the definition of PE that are included in this report will be among the changes proposed for inclusion in the **MLI** that will implement the results of the work on treaty issues mandated by the BEPS Action Plan. Also, in order to provide greater certainty about the determination of profits to be attributed to the PEs that will result from the changes included in this report and to take account of the need for additional guidance on the issue of attribution of profits to PEs, the OECD released discussion draft for additional guidance on the attribution of profits to PE's in July 2016. Considering the discussion drafts and the comments received thereon, the OECD on 22 March 2018 released a report on "*Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7*" which contains additional guidance on attribution of profits to PE resulting from the changes in this Action Plan and to Article 5 of the OECD MTC. The suggestions of this Action Plan against the artificial avoidance of PE status through commissionaire arrangements, specific activity exemptions and splitting of contracts have been included in the OECD MTC (2017 update) and the MLI.

In order to align the scope of business connection with the modified PE rule in line with this Action Plan and the MLI, India incorporated the concept of commissionaire arrangements vide Finance Act 2018 under section 9 of the Act⁹⁴.

⁹⁴Refer Module A

Action 8 to 10– Aligning Transfer Pricing Outcomes with Value Creation

Description of tasks and issues:

Over several decades and in step with the globalisation of the economy, world-wide intra-group trade has grown exponentially. Transfer pricing rules, which are used for income tax purposes, are concerned with determining the circumstances, including the price, for transactions within an MNE group resulting in the allocation of profits to group companies in different countries. The impact of these rules has become more significant for business and tax administrations with the growth in the volume and value of intragroup trade. As the Action Plan on BEPS (BEPS Action Plan, OECD, 2013) identified, the existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits. The work under Actions 8- 10 of the BEPS Action Plan has targeted this issue, to ensure that transfer pricing outcomes are aligned with value creation.

This Action Plan has focused on three key areas. Work under Action 8 addresses transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to BEPS. Work under Action 9 considered the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. It also addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company. Work under Action 10 focuses on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned, the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralizing the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

On 10 July 2017 the OECD released the *“Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”* which incorporates the clarifications and revisions agreed in BEPS Actions 8-10 and Action 13. The OECD invited public comments in relation to Actions 8-10 (“Assure that transfer pricing outcomes are in line with value creation”) 10 and published the public comments on 14 September 2018.

Action 11 – Measuring and monitoring BEPS

Description of tasks and issues:

The adverse fiscal and economic impacts of BEPS have been the focus of the OECD/G20 BEPS Project since its inception. While anecdotal evidence has shown that tax planning activities of some MNEs take advantage of the mismatches and gaps in the

international tax rules, separating taxable profits from the underlying value-creating activity, the Addressing BEPS report (OECD 2013) recognised that the scale of the negative global impacts on economic activity and government revenues have been uncertain. Measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations, today we know that the fiscal effects of BEPS are significant. The findings of the work performed since 2013 highlight the magnitude of the issue, with global corporate income tax (CIT) revenue losses estimated between 4% and 10% of global CIT revenues, i.e. USD 100 to 240 billion annually. Given developing countries' greater reliance on CIT revenues, estimates of the impact on developing countries, as a percentage of GDP, are higher than for developed countries. In addition to significant tax revenue losses, BEPS causes other adverse economic effects, including tilting the playing field in favour of tax-aggressive MNEs, exacerbating the corporate debt bias, misdirecting foreign direct investment (FDI), and reducing the financing of needed public infrastructure.

Six indicators (*classified in 5 categories as given below*) of BEPS activity highlight BEPS behaviors using different sources of data, employing different metrics and examining different BEPS channels. When combined and presented as a dashboard of indicators, they confirm the existence of BEPS and its continued increase in scale in recent years.

- The profit rates of MNE affiliates in lower-tax countries are higher than their group's average worldwide profit rate.
- Effective tax rates paid by large MNE entities are estimated to be 4 to 8½ percentage points lower than similar enterprises with domestic-only operations, tilting the playing-field against local businesses and non-tax aggressive MNEs, although some of this may be due to MNEs' greater utilisation of available country tax preferences.
- FDI is increasingly concentrated. FDI in countries with net FDI to GDP ratios of more than 200% increased from 38 times higher than all other countries in 2005 to 99 times higher in 2012.
- The separation of taxable profits from the location of the value creating activity is particularly clear with respect to intangible assets, and the phenomenon has grown rapidly. Royalties received by entities located in these low-tax countries accounted for 3% of total royalties, providing evidence of the existence of BEPS, though not a direct measurement of the scale of BEPS
- Debt from both related and third-parties are more concentrated in MNE affiliates in higher statutory tax-rate countries. The interest-to-income ratio for affiliates of the largest global MNEs in higher-tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio.

While recognising the need to maintain appropriate safeguards to protect the confidentiality of taxpayer information, this report makes a number of recommendations

that will improve the analysis of available data. Some of the information needed to improve the measurement and monitoring of BEPS is already collected by tax administrations, but not analysed or made available for analysis. The focus of the report's recommendations in this area is on improved access to and enhanced analysis of existing data, and new data proposed to be collected under Actions 5, 13 and, where implemented, Action 12 of the BEPS Project.

The report recommends that the OECD work with governments to report and analyse more corporate tax statistics and to present them in an internationally consistent way. For example, statistical analyses based upon Country-by-Country Reporting data have the potential to significantly enhance the economic analysis of BEPS. These improvements in the availability of data will ensure that governments and researchers will, in the future, be better able to measure and monitor BEPS and the actions taken to address BEPS.

Action 12 – Mandatory Disclosure Rules Description of tasks and issues:

One of the major challenges faced by tax authorities is lack of timely, comprehensive and relevant information. Tax aggressive strategies, because of this drawback may go unnoticed. Early access to such information provides the opportunity to quickly respond to tax risks through informed risk assessment, audits, or changes to legislation or regulations. Action 12 of the Action Plan on BEPS (OECD 2013) recognised the benefits of tools designed to increase the information flow on tax risks to tax administrations and tax policy makers. It therefore called for recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The Report provides a modular framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users. The recommendations in this Report do not represent a minimum standard and countries are free to choose whether or not to introduce mandatory disclosure regimes. Where a country wishes to adopt mandatory disclosure rules, the recommendations provide the necessary flexibility to balance a country's need for better and timelier information with the compliance burdens for taxpayers. The Report also sets out specific recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and cooperation between tax administrations.

The OECD in March 2018 released a report titled "Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures". The structure of these rules is based on the best practice recommendations of this Action Plan specifically targeting these types of arrangements and structures. Part I gives an overview of the model rules; Part II sets out the text of the rules; and Part III provides a

commentary on those rules.

Action 13 – Transfer pricing documentation and country-by-country (CbC) reporting

Description of tasks and issues:

This report contains revised standards for transfer pricing documentation and a template for CbC Reporting of income, taxes paid and certain measures of economic activity. Action 13 of the Action Plan on BEPS (BEPS Action Plan, OECD, 2013) requires the development of *“rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template”*. In response to this requirement, a three-tiered standardized approach to transfer pricing documentation has been developed. First, the guidance on transfer pricing documentation requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a “master file” that is to be available to all relevant tax administrations. Second, it requires that detailed transactional transfer pricing documentation be provided in a “local file” specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions. Third, large MNEs are required to file a CbC Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in. The countries participating in the BEPS project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviour. Jurisdictions endeavor to introduce, as necessary, domestic legislation in a timely manner. They are also encouraged to expand the coverage of their international agreements for exchange of information. Mechanisms will be developed to monitor jurisdictions’ compliance with their commitments and to monitor the effectiveness of the filing and dissemination mechanisms. The outcomes of this monitoring will be taken into consideration in the 2020 review.

On 10 July 2017 the OECD released the *“Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”* which incorporates the clarifications and revisions agreed in BEPS Actions 8-10 and Action 13. Further, in May 2018 the OECD released *“Country-by-Country Reporting – Compilation of Peer Review Reports (Phase 1)”*. The minimum standard of this Action Plan has been translated into specific terms of

reference and a methodology for the peer review process. The peer review of the minimum standard is proceeding in stages with three annual reviews in 2017, 2018 and 2019. The phased review process follows the phased implementation of CbC Reporting. Each annual peer review process will therefore focus on different aspects of the three key areas under review: the domestic legal and administrative framework, the exchange of information framework, and the confidentiality and appropriate use of CbC reports. This first annual peer review report reflects the outcome of the first review which focused on the domestic legal and administrative framework. It contains the review of 95 jurisdictions which provided legislation or information pertaining to the implementation of CbC Reporting. As on today, more than 110 jurisdictions have taken significant steps to enact domestic legislation mandating CbC reporting. A total of 88 jurisdictions have formalised either multilateral or bilateral competent authority agreements, enabling the exchange of CbC reports. Among the jurisdictions subjected to peer review, 90 have undergone assessments regarding the confidentiality and data protection safeguards applicable to reciprocal data exchange⁹⁵.

The three-tier documentation structure as per this Action Plan were introduced in India with effect from FY 2016-17. Insertion of section 286 and amendment to section 92D has been done vide Finance Act, 2016 and will be effective from AY 2017-18. The CbC and master file requirements were introduced in addition to the already existing local documentation requirements. Further, detailed Rules with respect to these filing requirements were also released in October, 2017 which were further clarified by way of amendments in Finance Act 2018⁹⁶

Action 14 – Make Dispute resolution mechanisms more effective.

Description of tasks and issues:

Eliminating opportunities for cross-border tax avoidance and evasion and the effective and efficient prevention of double taxation are critical to building an international tax system that supports economic growth and a resilient global economy. Countries agree that the introduction of the measures developed to address BEPS pursuant to the Action Plan on BEPS (OECD, 2013) should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues. Article 25 of the OECD MTC provides a mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or application of the Convention on a mutually agreed basis. This mechanism – the mutual agreement procedure (MAP) – is of fundamental importance to the proper application and interpretation of tax treaties, notably to ensure that taxpayers entitled to the benefits of

⁹⁵ OECD Secretary - General Tax Report to 20 Leaders, India, September 2023

⁹⁶ Amendments to section 286 by Finance Act, 2018

the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty. These measures are underpinned by a strong political commitment to the effective and timely resolution of disputes through the MAP and to further progress to rapidly resolve disputes.

Through the adoption of this Report, countries have agreed to important changes in their approach to dispute resolution, in particular by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20.

In addition to the commitment to implement the minimum standard by all countries adhering to the outcomes of the BEPS Project, the following countries have declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified timeframe: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States. This represents a major step forward as together these countries were involved in more than 90 percent of outstanding MAP cases at the end of 2013, as reported to the OECD.

In October, 2016, the OECD released key documents, approved by the inclusive framework on BEPS that will form the basis of the MAP peer review and monitoring process under this Action Plan. The peer review and monitoring process will be conducted by the Forum on Tax Administration MAP Forum in accordance with the Terms of Reference and Assessment Methodology, with all members participating on an equal footing. This minimum standard of this Action Plan requires members to:

1. Provide timely and complete reporting of MAP statistics based on a new MAP statistics reporting framework.
2. Publish their MAP profiles pursuant to an agreed template.

The stage one of peer review under this Action Plan-The peer review for the first batch of assessed jurisdictions started in December 2016 to ensure the implementation of the minimum standard to strengthen the effectiveness and efficiency of the MAP. The stage one peer review reports for the assessed jurisdictions of the first three batches includes the following jurisdictions Belgium, Canada, Netherlands, Switzerland, The United Kingdom, The United States, Austria, France, Germany, Italy, Liechtenstein, Luxembourg, Sweden, Czech Republic, Denmark, Finland, Korea, Norway, Poland, Singapore, Spain. India's peer review report, released in 2019, finds that India meets Action 14 Minimum Standard concerning prevention of tax disputes through its Advance Pricing Programme (APA). India provides access to MAP in transfer pricing cases concerning the application where treaty anti-abuse provisions are applied. The report

finds that MAP access is allowed only where there is double taxation and denied where there is no double taxation, which is contrary to the requirements of Article 25(1) of the OECD Model Convention. The Report finds that India meets the Minimum Standard in Article 14 of BEPS Actions as regards the implementation of MAP agreements. India also monitors their implementation.

It was further decided to review all Inclusive Framework members, starting in 2023 with the jurisdictions that have no or only limited experience in dispute resolution. The findings and outcomes of these reviews are being discussed during meetings of the Forum on Tax Administration (FTA) MAP Forum, with the first reports deliberated upon in the July session and subsequent batches currently under consideration in the September meeting.

Action 15 – Developing a Multilateral Instrument to modify bilateral tax treaties

Description of tasks and issues:

Endorsing the Action Plan on BEPS (OECD, 2013) by the Leaders of the G20 in Saint-Petersburg in September 2013 shows unprecedented political support to adapt the current international tax system to the challenges of globalisation. DTAAAs are based on a set of common principles designed to eliminate double taxation that occurs in the case of cross-border trade and investments. The contents of OECD and UN Model Tax Conventions are reflected in thousands of bilateral agreements among jurisdictions. Globalisation has exacerbated the impact of gaps and frictions among different countries' tax systems. As a result, some features of the current bilateral tax treaty system facilitate BEPS and need to be addressed. Beyond the challenges faced by the current tax treaty system on substance, the sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. Even where a change to the OECD MTC is consensual, it is a *fait accompli* that substantial amount of time and resources are used to introduce it into most bilateral tax treaties. As a result, the current network is not well-synchronized with the MTCs, and issues that arise over time cannot be addressed swiftly. Without a mechanism to swiftly implement them, changes to models only make the gap between the content of the models and the content of actual tax treaties wider. This will contradict the objective to strengthen the current system by putting an end to BEPS, in part by modifying the bilateral treaty network. Doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation. For this reason, governments have agreed to explore the feasibility of a MLI that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

This Action Plan provides for an analysis of the tax and public international law issues related to the development of a MLI to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested countries will develop a MLI designed to provide

an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The goal of this Action Plan is to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world, but precedents for modifying bilateral treaties with a MLI exist in various other areas of public international law. Drawing on the expertise of public international law and tax experts, the 2014 Report, explored the technical feasibility of a multilateral hard law approach and its consequences on the current tax treaty system. It identified the issues arising from the development of such an instrument and provided an analysis of the international tax, public international law, and political issues that arise from such an approach. The 2014 Report also concluded that a MLI is desirable and feasible, and that negotiations for such an instrument should be convened quickly. Based on this analysis, a mandate for the formation of an ad hoc Group ("the Group") to develop a MLI on tax treaty measures to tackle BEPS was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. Participation in the development of the MLI is voluntary and does not entail any commitments to sign such instrument once it has been finalized. The Group began its work in May 2015 with the aim to conclude its work and opened the MLI for signature on 31 December 2016. On 7 June 2017, 68 countries signed the "*Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting*" in Paris. The MLI may be considered as one of the key outcomes of the BEPS project which would ensure implementation of the recommendations of the Action Plans. It would work as a guide for jurisdictions to choose from the given recommendations and also to mandate compliance with minimum standards. The MLI may not automatically apply to all the treaties of a country that is a signatory to the MLI but will apply only in those tax treaties where both the countries have conveyed their intention to include the other country to be covered by the MLI. This is referred to as Covered Tax Agreements (CTA).

On 17 May, 2017 the Union Cabinet of India gave an approval to enter into MLI. As aforesaid, India is a signatory to the MLI and had approximately 93 countries in its list of CTAs. The MLI do not replace the existing tax treaties albeit are designed to be read alongside the tax treaties.

The basic structure of every Article in the MLI comprises of the following-

- (i) *BEPS Measure* - The substantive measure recommended for adoption in the various BEPS Action Plans.
- (ii) *Compatibility Clause* - Explains the mode in which the substantive measure will be incorporated in the tax treaty, whether it will apply in absence of a similar provision or whether it will overrule provisions which are incompatible or whether it will replace the relevant provisions.

- (iii) *Reservations* - A country can choose to reserve its right in respect of certain articles or provisions within the articles unless they prescribe minimum standards.
- (iv) Notification clause is provided for a country to opt in a provision, for notifying preferred option, for notifying similar provision that will be replaced or overruled, for notifying reservation if any.

The MLI recommends certain minimum standards- Article 6- Preamble of CTA, Article 7- Prevention of treaty abuse and Article 16- MAP for improvement of dispute resolution. The signatories to the MLI are expected to adhere to these minimum standards. Countries can opt out of these minimum standards only in case their existing treaties already provide for such similar minimum standards.

10. Conclusion

It is pertinent to note that in spite of the above Action Plans being mere recommendations, quite a few countries have already adopted and/or implemented many of the measures recommended out of the Action Plans and many countries are still in the process of adopting them.

It is necessary that the Action Plans when incorporated, in the tax system of a country discourages BEPS strategies. The gaps in the existing tax rules of different countries promote BEPS strategies. This (gap in tax rules) coupled with the ability of the MNEs to allocate profits to different jurisdictions results in BEPS strategies from a high tax jurisdiction to a low tax jurisdiction. To ensure success of these Action Plans to counter BEPS, one of the most important points to be considered is that there is a requirement for the countries to realign their tax system which minimises the gaps prevailing in the existing system. Going forward, if the said realignment does not see the light of the day; it is very likely that the gaps may widen. Such consequences are not desirable considering the existing economic scenario.

Given that blueprint of Pillar 1 and Pillar 2 proposals have been released and countries have started opting for Pillar 2 to end the tax avoidance practices, a lot will depend on the smooth implementation of the proposals across the world and consensus of the countries for a uniform solution.

Module C

Model Tax Conventions on Double Tax Avoidance

Unit-I	Comparative Analysis of all Articles of OECD, UN and US Model Conventions
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This comparative analysis of OECD, UN and US Model Conventions has been made in a tabular format for ease of reference, easy identification of different words, phrases, sentences, clauses and paragraphs used / omitted in the various articles of these Model Conventions. To highlight the differences in the text of various articles of the Model Conventions and for ease of understanding, emphasis by way of **Bold**, **Bold and Italics** and **Bold, Italics and underline**, have been used appropriately, as explained in the Notes given in the beginning of the Comparative Table given below. This chapter should be read along with changes introduced by Multilateral Instrument signed by India, as discussed at Module G.

Necessary brief comments about identical language, similarities, differentiations and other relevant observations in a summarised manner have been given below each clause/para of various articles for facilitating proper understanding of the comparative analysis.

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
NOTE:			
a.	<i>The Comparative Analysis and Article wise / Para-wise Chart have been prepared taking OECD Model Convention as base. The comparative differentiating words have been highlighted in Bold in OECD Model column, at appropriate places for ease of identification and reading.</i>		
b.	Additional Paras, Phrases in UN and US Model as compared to OECD Model have been shown in Bold and Italics.		
c.	Changes in Words, Phrases, Sentences etc. in UN and US Model as compared to OECD Model have been shown in Bold, Italics & Underlined at appropriate places in the comparative similar paragraphs.		
d.	<i>As far as possible, articles, paras and clauses similar to those in OECD Model</i>		

3.2 International Tax — Practice

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
	<i>have been placed in parallel Columns in UN and US Models.</i>		
1	PERSONS COVERED	PERSONS COVERED	GENERAL SCOPE
	This Convention shall apply to persons who are residents of one or both of the Contracting States.	This Convention shall apply to persons who are residents of one or both of the Contracting States.	1. This Convention shall apply only to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.
2.	For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.	For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.	2. This Convention shall not restrict in any manner any benefit now or hereafter accorded: a) by the laws of either Contracting State; or b) by any other agreement to which the Contracting States are parties.
3.	This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under [paragraph 3 of	This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 2 of Article	3(a) Notwithstanding the provisions of subparagraph b) of paragraph 2 of this Article: i) for purposes of paragraph 3 of Article

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
	<p>Article 7], paragraph 2 of Article 9 and Articles 19, 20, 23[A] [B] 24,25,28</p>	<p>9, [paragraph 2 of Article 18 (Alternative A) or paragraph 3 of Article 18 (Alternative B)] and Articles 19, 20, [23 A or 23 B], 24, [25 (Alternative A) or 25 (Alternative B)] and 28.</p>	<p><i>XXII (Consultation) of the General Agreement on Trade and Services, the Contracting States agree that any question arising as to the interpretation or application of this Convention and, in particular, whether a taxation measure is within the scope of this Convention, shall be determined exclusively in accordance with the provisions of Article 25 (Mutual Agreement Procedure) of this Convention; and</i></p> <p><i>ii) the provisions of Article XVII of the General Agreement on Trade in Services shall not apply to a taxation measure unless the competent authorities agree that the measure is not within the scope of Article 24 (Non-Discrimination) of this Convention.</i></p>
			<p><i>3(b) For the purposes of this paragraph, a “measure” is a law, regulation, rule, procedure, decision,</i></p>

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<i>administrative action, or any similar provision or action.</i>
			<p>4. Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens.</p> <p>Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of that Contracting State.</p>
			<p>5. The provisions of paragraph 4 shall not affect:</p> <p>a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), paragraphs 1 b), 2, and 5 of Article 17 (Pensions, Social Security, Annuities,</p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>Alimony, and Child Support), paragraphs 1 and 4 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and</i></p> <p><i>b) the benefits conferred by a Contracting State under paragraph 2 of Article 18 (Pension Funds), Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.</i></p>
			<p><i>6. An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<i>purposes of the taxation law of sub Contracting State as the income, profit or gain of a resident.</i>
			<i>7. An item of income, profit or gain arising in one of the Contracting States otherwise would be entitled to the benefits of this Convention in that Contracting State and, under the law of the other Contracting State, a person's tax in respect of such item is determined by reference to the amount thereof that is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the amount as is taxed in the other Contracting State.</i>
			<i>8. Where an enterprise of a Contracting State derives income from the</i>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>other Contracting State, and the first-mentioned Contracting State treats that income as attributable to a permanent establishment situated outside of that Contracting State, the benefits of this Convention shall not apply to that income if:</i></p> <p><i>a) the profits that are treated as attributable to the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the state in which the permanent establishment is situated that is less than the lesser of (i) 15 percent or (ii) 60 percent of the general statutory rate of company tax applicable in the first-mentioned Contracting State; or</i></p> <p><i>b) permanent establishment is situated in a third state that does not have a comprehensive convention for the</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>avoidance of double taxation in force with the Contracting State from which the benefits of this Convention are being claimed, unless the first-mentioned Contracting State includes the income treated as attributable to the permanent establishment in its tax base.</i></p> <p><i>However, if a resident of a Contracting State is denied the benefits of this Convention pursuant to this paragraph, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention with respect to a specific item of income if such competent authority determines that such grant of benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of</i></p>

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			<i>the Contracting State to which the request has been made shall consult with the competent authority of the other Contracting State before either granting or denying a request made under this paragraph by a resident of that other Contracting State.</i>

Comments

UN & OECD Models: Article 1 of the OECD Model is **identical** to Article 1 of the UN Model. Article 2 of the OECD Model is **identical** to Article 2 of the UN Model. The differences between OECD and UN Models in Article 3 have been highlighted in UN Model column.

US & OECD/UN Models: The differences between OECD/UN and US Models have been highlighted in the US Model column. The additional paragraphs Nos. 2 to 6 in the US Model have been highlighted.

India-US DTAA: The scope of the application of the said treaty to residents of India and/or the US is subservient to any contra provisions of the treaty.

Article 1(2) did not create new tax liability and it cannot be interpreted to mean that the other Contracting State is also bound to grant tax exemption under its domestic tax laws to a tax exempted resident of a Contracting State. **[Population Council Inc. [2006] 286 ITR 243 (AAR)]**

In light of Article 1(3), the US has a right to tax its citizens even though they may be residents of India.

Articles 1(3) and 1(4) of the India-US Tax Treaty contain additional provisions on the “general scope” of the said treaty for which the Technical Explanation to the India-US Tax Treaty could be referred.

2	TAXES COVERED	TAXES COVERED	TAXES COVERED
1.	This Convention shall apply to taxes on income and on capital imposed on behalf of a	This Convention shall apply to taxes on income and on capital imposed on behalf of a	This Convention shall apply to taxes on income imposed on behalf of a Contracting State

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	Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.	Contracting State or of its political subdivisions or local authorities , irrespective of the manner in which they are levied.	irrespective of the manner in which they are levied.
<p>Comments UN & OECD Models: Article 2(1) of the OECD Model and Article 2(1) of the UN Model are identically worded. US & OECD /UN Models: The differences between OECD/UN and US Models have been highlighted in bold and italics in the UN Model column. The US Model does not apply to taxes on capital. Further it does not apply to taxes imposed on behalf of its political subdivisions or local authorities.</p>			
2	There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.	There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital , or on elements of income or of capital , including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.	There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of property.
<p>Comments UN & OECD Models: Article 2(2) of the OECD Model and Article 2(2) of the UN Model are identically worded. US & OECD /UN Models: The differences between OECD/UN and US Models have been</p>			

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
highlighted in the UN Model column.			
3	The existing taxes to which the Convention shall apply are in particular: a) (in State A): b) (in State B):	The existing taxes to which the Convention shall apply are in particular: a) (in State A): b) (in State B):	The existing taxes to which this Convention shall apply are: a) in the case of -----: b) in the case of the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding social security and unemployment taxes), and the Federal excise taxes imposed with respect to private foundations.
<p>Comments</p> <p>UN & OECD Models: Article 2(3) of the OECD Model and Article 2(3) of the UN Model are identically worded.</p> <p>US & OECD /UN Models: The differences between OECD/UN and US Models have been highlighted in the US Model column.</p>			
4	The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify	The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each	This Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes that have been made in their

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	each other of any significant changes that have been made in their taxation laws.	other of significant changes made to their tax law.	respective taxation or other laws that significantly affect their obligations under this Convention.
<p>Comments</p> <p>UN & OECD Models: Article 2(4) of the OECD Model uses the expression “taxation laws” while Article 2(4) of the UN Model uses the expression “tax law” (The pre-1999 version of the UN Model used the expression “taxation laws”).</p> <p>US & OECD /UN Models: The differences between OECD/UN and US Models have been highlighted in the US Model column.</p>			
3	GENERAL DEFINITIONS	GENERAL DEFINITIONS	GENERAL DEFINITIONS
1 1(a)	For the purposes of this Convention, unless the context otherwise requires: the term "person" includes an individual, a company and any other body of persons;	For the purposes of this Convention, unless the context otherwise requires: 1(a) The term "person" includes an individual, a company and any other body of persons;	For the purposes of this Convention, unless the context otherwise requires: the term "person" includes an individual, an estate, a trust, a partnership , a company, and any other body of persons;
<p>Comments</p> <p>UN & OECD Models: Article 3(1)(a) of the OECD Model is identical to Article 3(1)(a) of the UN Model.</p> <p>US & OECD /UN Models: The differences between OECD/UN and US Models have been highlighted in the US Model column.</p>			
1(b)	the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;	1(b)The term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes;	the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes according to the laws of Contracting State in which it is

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			<i>resident.</i>
<p>Comments UN & OECD Models: Article 3(1)(b) of the OECD Model is identical to Article 3(1)(b) of the UN Model. US & OECD /UN Models: The differences between OECD/UN and US Models have been highlighted in the US Model column.</p>			
1(c)	the term "enterprise" applies to the carrying on of any business;	-	1(d) the term "enterprise" applies to the carrying on of any business;
1(d)	the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;	1(c) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;	1(c) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State, and an enterprise carried on by a resident of the other Contracting State; <i>the terms also include an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State;</i>
<p>Comments UN & OECD Models: Article 3(1)(d) of the OECD Model is identical to Article 3(1)(c) of the UN Model. Unlike the UN Model, Article 3(1)(c) of the OECD Model additionally defines the term "enterprise" as applying "to the carrying on of any business". Thus, the term means any activity or set of activities that constitute the carrying on of a "business". Article 3(1)(h) of the OECD Model defines "business" to expressly include the "performance of professional services and of other activities of an independent character"; hence, on a combined reading</p>			

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<p>of the two definitions, the expression “enterprise” includes performance of such services/activities notwithstanding anything to the contrary in the domestic law para 4 and the income from such activities is dealt with under Article 7 (Business Profits) and not Article 21 (Other Income) of the OECD Model.</p> <p>US & OECD /UN Models: Article 3(1) (d) of the US Model is identical to Article 3(1)(c) of the OECD Model. Article 3(1) (d) of the OECD Model is similar to Article 3(1)(c) of the US Model with additional explanatory sentence at the end, which has been highlighted in US Model column.</p>			
1(e)	the term “international traffic” means any transport by a ship or aircraft, except when the ship or aircraft is operated solely between places in a Contracting State <i>and the enterprise that operates the ship or aircraft is not an enterprise of that State</i>	1(d) The term “international traffic” means any transport by a ship or aircraft, except when the ship or aircraft is operated solely between places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State	1(f) the term "international traffic" means any transport by a ship or aircraft, except when such transport is solely between places in a Contracting State;
<p>Comments</p> <p>UN & OECD Models: Article 3(1)(e) of the OECD Model is identical to Article 3(1)(d) of the UN Model.</p> <p>US & OECD /UN Models: Article 3(1)(e) of the OECD/UN Model is similar to Article 3(1)(f) of the US Model with some modifications, which has been highlighted in UN Model column.</p>			
1(f)	the term "competent authority" means: (i) (in State A): (ii) (in State B):	1(e)-The term "competent authority" means: (i) (In State A): (ii) (In State B):	1(g) the term "competent authority" means: i) in ----, ----- -----; and ii) in the United States: the Secretary of the Treasury or his delegate;
<p>Comments</p> <p>UN & OECD Models: Article 3(1)(f) of the OECD Model is identical to Article 3(1)(e) of the</p>			

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UN Model. US & OECD /UN Models: Article 3(1)(f) of the OECD Model is similar to Article 3(1)(g) of the US Model with some modifications, which has been highlighted in US Model column.			
1(g)	the term "national", in relation to a Contracting State, means: (i) any individual possessing the nationality or citizenship of that Contracting State; and (ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State;	1(f) The term "national" means: (i) Any individual possessing the nationality of a Contracting State; (ii) Any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.	1(j) the term "national" of a Contracting State means: i) any individual possessing the nationality or citizenship of that State; and ii) any legal person, partnership or association deriving its status as such from the laws in force in that State;
Comments UN & OECD Models: The definition of "national" in Article 3(1)(g) of the OECD Model is identical to the UN Model, except that for natural persons (individuals), the OECD Model incorporates alternative criteria of "citizenship". US & OECD /UN Models: Article 3(1)(g) of the OECD Model is similar to Article 3(1)(j) of the US Model with some modifications, which has been highlighted in US Model column.			
1(h)	the term "business" includes the performance of professional services and of other activities of an independent character.		1(e) the term "business" includes the performance of professional services and of other activities of an independent character;
			1(h) the term "-----" means;
			1(i) the term "United States" means the United

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			<i>States of America, and includes the states thereof and the District of Columbia; such term also includes the territorial sea thereof and the sea bed and subsoil of the submarine areas adjacent to that territorial sea, over which the United States exercises sovereign rights in accordance with international law; the term, however, does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory;</i>
	<p>Comments</p> <p>UN & OECD Models: Article 3(1)(h) of the OECD Model defines “Business” as including the “performance of professional services and of other activities of an independent character”. This definition was included to enable income from independent personnel services to be taxed under Article 7 of the OECD Model, consequent to deletion of Article 14 in the OECD in the OECD Model, and not under Article 21 (Other Income).</p> <p>The UN Model does not define the term “Business”. Section 2(13) of the Income-tax Act, 1961 defines the term ‘Business’, which definition could be applied subject to Article 3(2).</p> <p>US & OECD Models: Article 3(1)(h) of the OECD Model is similar to Article 3(1)(e) of the US Model with modifications/additional clauses, which has been highlighted in US Model column.</p>		
	1(i) the term “recognised pension fund” of a State means	1(g) The term “recognized pension fund” of a Contracting	1(k) the term “pension fund” means any fund established in a

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	<p>an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:</p> <p>(i) that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or</p> <p>(ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision (i)</p>	<p>State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:</p> <p>(i) that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities, or</p> <p>(ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements to which subdivision (i) applies.</p>	<p><i>Contracting State that is:</i></p> <p><i>i) generally exempt from income taxation in that State; and</i></p> <p><i>ii) operated principally either:</i></p> <p><i>A) to administer or provide pension or retirement benefits; or</i></p> <p><i>B) to earn income for the benefit of one or more persons described in clause A).</i></p>
<p>Comments UN & OECD Models: Article 3(1)(g) of the UN Model defines ‘Recognised Pension Fund’</p>			

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<p>which is similar to the definition given in Article 3(1)(i) of the OECD Model.</p> <p>US & OECD Models: Article 3(1)(k) of the US model tax convention is defined differently as compared to Article 3(1)(i) of the OECD Model convention, which has been highlighted in US Model column.</p>			
2	<p>As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.</p>	<p>As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.</p>	<p>As regards the application of the Convention at any time by a Contracting State any term not defined therein shall, unless the context otherwise requires, or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that contracting State.</p>
<p>Comments</p> <p>UN & OECD Models: Article 3(2) of the OECD Model is identical to Article 3(2) of the UN Model with modifications, which has been highlighted in OECD Model column</p> <p>US & OECD Models: Article 3(2) of the OECD Model is similar to Article 3(2) of the US Model with modifications, which has been highlighted in US Model column.</p>			

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4	RESIDENT	RESIDENT	RESIDENT
1	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, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, 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.	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 that person's domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognized pension fund of that State. This term, however, 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.	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, citizenship , <i>place of management</i> , <i>place of incorporation</i> , or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State.
			2. The term "resident of a Contracting State" includes: a) a pension fund established in that State; and

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			<p><i>b) an organization that is established and maintained in that State exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that State.</i></p>
<p>Comments</p> <p>UN & OECD Models: Article 4(1) of the OECD Model does not differ from Article 4(1) of the UN Model except that the UN Model has added the criterion of “place of incorporation” to the list of criteria for residency. Also the UN model uses the phrase “that person’s domicile” whereas OECD uses the phrase “his domicile” Modifications are highlighted in the UN model convention. The addition in 2021 version of UN model is addition of “as well as a recognized pension fund of that State” in the definition.</p> <p>US & OECD Models Article 4(1) of the OECD Model is similar to Article 4(1) of the US Model with modifications, which has been highlighted in US Model column. In addition, US Model has Article 4(2) which explains the term ‘resident of a contracting state’. There is no corresponding article as article 4(2) of US Model, in UN or OECD model conventions.</p>			
2	<p>Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:</p> <p>a) he shall be deemed to be a resident only of the State in which he</p>	<p>Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:</p> <p>(a) he shall be deemed to be a resident only of the State in which he</p>	<p>3. Where, by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:</p> <p>a) he shall be deemed to be a resident only of the State in which he has a permanent home available</p>

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	<p>has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);</p> <p>b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;</p> <p>c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;</p> <p>d) if he is a national of both States or of neither of them, the competent authorities of the Contracting</p>	<p>has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);</p> <p>(b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;</p> <p>(c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;</p> <p>(d) If he is a national of both States or of neither of them, the competent authorities</p>	<p>to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (center of vital interests);</p> <p>b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;</p> <p>c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;</p> <p>d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement.</p>

3.22 International Tax — Practice

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	States shall settle the question by mutual agreement.	of the Contracting States shall settle the question by mutual agreement.	
<p>Comments</p> <p>UN & OECD Models: Article 4(2) of the OECD Model is identical to Article 4(2) of the UN Model.</p> <p>US & OECD Models: Article 4(2) of the OECD Model is similar to Article 4(3) of the US Model with minor modification, which has been highlighted in US Model column.</p>			
3	Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not	Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax	4. Where by reason of the provisions of paragraph 1 of this Article a company is a resident of both Contracting States, such company shall not be treated as a resident of either Contracting State for purposes of its claiming the benefits provided by this Convention.

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	be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.	provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.	
			5. Where by reason of the provisions of paragraph 1 of this Article a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavor to determine the mode of application of this Convention to that person.
<p>Comments</p> <p>UN & OECD Models: Article 4(3) of the OECD Model is identical to Article 4(3) of the UN Model.</p> <p>US & OECD Models: Article 4(3) of the OECD Model is similar to Article 4(4) of the US Model with certain modifications and additional paragraph 4(5) which have been highlighted in US Model column.</p>			
5	PERMANENT ESTABLISHMENT	PERMANENT ESTABLISHMENT	PERMANENT ESTABLISHMENT
1	For the purposes of this Convention, the term "permanent establishment" means a fixed place of	For the purposes of this Convention, the term "permanent establishment" means a fixed place of	For the purposes of this Convention, the term "permanent establishment" means a fixed place of business

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	business through which the business of an enterprise is wholly or partly carried on.	business through which the business of an enterprise is wholly or partly carried on.	through which the business of an enterprise is wholly or partly carried on.
<p>Comments UN & OECD Models: Article 5(1) of the OECD Model is identical to Article 5(1) of the UN Model. US & OECD Models: Article 5(1) of the OECD Model is identical to Article 5(1) of the US Model.</p>			
2	The term "permanent establishment" includes especially: (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop, and (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.	The term "permanent establishment" includes especially: (a) A place of management; (b) A branch; (c) An office; (d) A factory; (e) A workshop; (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.	The term "permanent establishment" includes especially: (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; and (f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.
<p>Comments UN & OECD Models: Article 5(2) of the OECD Model is identical to Article 5(2) of the UN Model. US & OECD Models: Article 5(2) of the OECD Model is identical to Article 5(2) of the US Model.</p>			
3	A building site or construction or installation project constitutes a permanent establishment only if it	<i>The term "permanent establishment" also encompasses:</i> (a) A building site, a construction, <i>assembly</i> or	<i>A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration of natural resources, constitutes a</i>

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	lasts more than twelve months .	<p><i>installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;</i></p> <p><i>(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned.</i></p>	<p>permanent establishment only if it lasts, or the exploration activity continues for more than twelve months. For the sole purpose of determining whether the twelve-month period referred to in this paragraph has been exceeded:</p> <p>(a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during periods of time that in the aggregate do not last more than twelve months; and</p> <p>(b) connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding thirty days, by one or more enterprises that are connected persons with respect to the first-mentioned enterprise, these different periods of</p>

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			<i>time shall be added to the periods of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.</i>
<p>Comments</p> <p>UN & OECD Models: Article 5(3) of the OECD Model differs from Article 5(3)(a) of the UN Model as follows:</p> <ul style="list-style-type: none"> • The OECD Model does not specifically mention “assembly” and “supervisory” activities in connection with building sites and construction, assembly or installation projects. • Article 5(3)(b) of the UN Model covers a broader range of activities than Article 5(3) of the OECD Model and the OECD Model increases the threshold from six months to twelve months. • A provision corresponding to Article 5(3)(b) is absent in the OECD model as a consequence of which a “Service PE” under the OECD Model has to be ascertained in accordance with the principles of Article 5(1). <p>US & OECD Models: Article 5(3) of the OECD Model is similar to Article 5(3) of the US Model with modifications, which has been highlighted in US Model column.</p>			
4	Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include: (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the	Notwithstanding the preceding provisions of this article, the term "permanent establishment" shall be deemed not to include: (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise; (b) The maintenance of	Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include: (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; (b) the maintenance of a

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	<p>enterprise;</p> <p>(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;</p> <p>(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;</p> <p>d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;</p> <p>(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;</p>	<p>a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;</p> <p>(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;</p> <p>(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;</p> <p>(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.</p>	<p>stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;</p> <p>(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;</p> <p>(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;</p> <p>(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;</p>

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	(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.	(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that such activity or, in the case of subparagraph (f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.	(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) through e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
<p>Comments</p> <p>UN & OECD Models: Unlike the OECD Model, Article 5(4)(a) of the UN Model does not include “delivery” and restricts sub-paragraph (a) to “storage” or “display”. The word “delivery” is deleted in the UN Model because stocking of goods in State S for ensuring quick delivery to the customers facilitates sales of the products and thereby earning of profit in State S. Consequently, a warehouse in state used for “delivery” would be a PE under the UN Model. However, little income could be attributed to this activity.</p> <p>The OECD Model, unlike Article 5(4)(a) and 5(4)(b) of the UN Model, also excludes from the purview of PE, facilities solely for the purpose of “delivery” in State S of goods or merchandise belonging to the foreign enterprise. However, the exclusion is only for “delivery” and hence, a PE could exist under the OECD Model if such enterprise also renders “other” services in State S such as repair or maintenance. A PE also exists under the OECD Model when the “delivery” in state S by a foreign enterprise is in respect of goods belonging to another enterprise; however, where the transportation in State S is in respect of its own goods and such transportation by the foreign enterprise is merely incidental to its business (e.g., manufacturing goods), then the transportation activity falls within the exception of “delivery” as mentioned in Article 5(4)(a) of the OECD Model.</p> <p>US & OECD Models: Article 5(3) of the OECD Model is similar to Article 5(3) of the US Model with modifications, which has been highlighted in US Model column.</p>			

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4.1	<p>Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and</p> <p>a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or</p> <p>b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities</p>	<p>Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and:</p> <p>(a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or</p> <p>(b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business</p>	

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	carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.	activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.	
5	Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person – is acting in a Contracting State on behalf of an enterprise ,in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are a) in the name of the enterprise, or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that	Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 7, where a person is acting in a Contracting State on behalf of an enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, if such a person: (a)habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely	Notwithstanding the provisions of paragraphs 1 and 2, where a person -- other than an agent of an independent status to whom paragraph 6 applies -- is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts that are binding on the enterprise , that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities that the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 that, if exercised through a fixed place of business, would not make this fixed place of business a

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	<p>enterprise or that the enterprise has the right to use, or c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.</p>	<p>concluded without material modification by the enterprise, and these contracts are (i) in the name of the enterprise, or (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or (iii) for the provision of services by that enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or (b) <i>the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of</i></p>	<p>permanent establishment under the provisions of that paragraph.</p>

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		<p><i>such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise on behalf of the enterprise.</i></p>	
		<p>6. Notwithstanding the preceding provisions of this Article but subject to the provisions of paragraph 7, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person.</p>	
<p>Comments UN & OECD Models: Article 5(5) of the OECD Model is similar to Article 5(5)(a) of the UN Model with minor difference in the language. Article 5(5)(b) of UN Model is absent in the OECD Model. Article 5(5) of the UN Model is broader in scope than Article 5(5) of the OECD Model. The UN Model has additional Article 5(6) relating to insurance which is absent in OECD Model. Accordingly, under the OECD Model, a PE of an insurance Enterprise has to be determined in accordance with provisions of Article 5 of the OECD model.</p>			

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<p>US & OECD Models: Article 5(5) of the OECD Model is similar to Article 5(5) of the US Model with minor difference in the language, which has been highlighted in US Model column.</p>			
6	<p>Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise</p>	<p>7. Paragraphs 5 and 6 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business.</p> <p>Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.</p>	<p>6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as <i>independent agents</i>.</p>
<p>Comments US & OECD Models: Article 5(6) of the OECD Model is similar to Article 5(6) of the US Model with minor difference in the language</p>			

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7	The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.	8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.	7. The fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State, or that carries on business in that other State (whether through a permanent establishment or otherwise), shall not be taken into account in determining whether either company has a permanent establishment in that other State.
8.	For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one	9. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50	-

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	<p>possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.</p>	<p>per cent of the beneficial interest in the other (or, in the case of a company, more than 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises</p>	
<p>Comments UN & OECD Models: Article 5(7) of the OECD Model is identical to Article 5(8) of the UN Model. US & OECD Models: Article 5(7) of the OECD Model is similar to Article 5(7) of the US Model with difference in the language, which has been highlighted in US Model column.</p>			

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6	INCOME FROM IMMOVABLE PROPERTY	INCOME FROM IMMOVABLE PROPERTY	INCOME FROM REAL PROPERTY
1	Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.	Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.	Income derived by a resident of a Contracting State from <i>real property, including income from agriculture or forestry</i> , situated in the other Contracting State may be taxed in that other State.
<p>Comments</p> <p>UN & OECD Models: Article 6(1) of the OECD Model is identical to Article 6(1) of the UN Model.</p> <p>US & OECD Models: Article 6(1) of the OECD Model is similar to Article 6(1) of the US Model with difference, which has been highlighted in US Model column.</p>			
2	The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting	The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting	The term “ <i>real property</i> ” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to <i>real property (including livestock and equipment used in agriculture and forestry)</i> , rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to

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	landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.	landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.	variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. <i>Ships and aircraft shall not be regarded as real property.</i>
<p>Comments UN & OECD Models: Article 6(2) of the OECD Model is identical to Article 6(2) of the UN Model. US & OECD Models: Article 6(2) of the OECD Model is similar to Article 6(2) of the US Model with differences, which have been highlighted in US Model column.</p>			
3	The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.	The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.	The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of real property.
<p>Comments UN & OECD Models: Article 6(3) of the OECD Model is similar to Article 6(3) of the UN Model except the addition of the word ‘also’ in UN Model. US & OECD Models: Article 6(3) of the OECD Model is almost similar to Article 6(3) of the US Model with minor change in language, which has been highlighted in US Model column.</p>			
4	The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of	The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of	The provisions of paragraphs 1 and 3 shall also apply to the income from real property of an enterprise.

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	an enterprise.	an enterprise <i>and to income from immovable property used for the performance of independent personal services.</i>	
			<i>A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were business profits attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the Contracting State in which the property is situated agrees to terminate the election.</i>
<p>Comments UN & OECD Models: Article 6(4) of the OECD Model does not have the words “and to income from immovable property used for the performance of independent personal services” which are present in Article 6(4) of the UN Model. This is consequent to deletion</p>			

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<p>of Article 14 in the OECD Model.</p> <p>US & OECD/UN Models: The second para of Article 6(4) in the US Model is absent in both OECD and UN Model, which has been highlighted in US Model column.</p>			
7	BUSINESS PROFITS	BUSINESS PROFITS	BUSINESS PROFITS
1	<p>The 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. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provision of paragraph 2 may be taxed in that other state.</p>	<p>The 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. 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 is attributable to</p> <p>(a) that permanent establishment;</p> <p>(b) <i>sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or</i></p> <p>(c) <i>other business activities carried on in that other State of</i></p>	<p>The 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. 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 of this Article may be taxed in that other Contracting State.</p>

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		<i>the same or similar kind as those effected through that permanent establishment.</i>	
<p>Comments</p> <p>UN & OECD Models: Article 7(1) of the OECD and UN Models are similar except that Article 7(1) of the OECD Model does not incorporate the “Force of Attraction” rule, which is incorporated in UN Model. Further, due to deletion of Article 14 in the OECD Model [which continues to remain in UN Model], income derived from furnishing of independent personnel services falls under Article 7 of the OECD Model.</p> <p>US & OECD Models: Article 7(1) of the OECD Model is almost similar to Article 7(1) of the US Model.</p>			
2	<p>For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar</p>	<p><i>Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under</i></p>	<p>For the purposes of this Article, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 of this Article are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts</p>

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	conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.	the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.	of the enterprise.
<p>Comments</p> <p>UN & OECD Models: Article 7(2) of both the OECD and UN Models advocate a distinct and separate entity approach for attribution of profits to a PE with difference in language. In addition, Article 7(2) of the OECD model makes a reference to FAR Analysis [Functions, Assets and Risks] which is absent in Article 7(2) of the UN Model.</p> <p>US & OECD Models: Article 7(2) of the US Model is similar to Article 7(2) of the OECD Model.</p>			
3.		In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.	Where, in accordance with paragraph 2 of this Article, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other Contracting State, the other Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it

3.42 International Tax — Practice

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p><i>However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment.</i></p> <p><i>Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards</i></p>	<p>agrees with the adjustment made by the first-mentioned Contracting State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.</p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p><i>reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.</i></p>	
<p>Comments UN & OECD Models: Article 7(3) of the UN Model relating to deduction of expenses, is absent in OECD Model.</p>			
3	<p>Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly</p>		

3.44 International Tax — Practice

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
	<p>profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.</p>		
<p>Comments Article 7(3) of the OECD Model and US Model relating to appropriate adjustment to tax necessary to eliminate double taxation, is absent in UN Model.</p>			
		<p>4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.	
<p>Comments Article 7(4) of the UN Model relating to determination of the profits to be attributed to a PE on the basis of an apportionment of the total profits of the enterprise to its various parts, is absent in the OECD Model and also in the US Model.</p>			
		5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.	
<p>Comments US & UN Models: Article 7(5) of the UN relating to use of same method for attribution of profits to a PE year by year unless there is good and sufficient reason to the contrary, is absent in OECD Model and US Model.</p>			
4	Where profits include items of income which are dealt with separately in other	6. Where profits include items of income which are dealt with separately in other	4. Where profits include items of income that are dealt with separately in other Articles of the

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
	Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.	articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.	Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.
<p>Comments UN, OECD & US Models: Article 7(4) of the OECD Model and US Model is identically worded as Article 7(6) of the UN.</p>			
			<p>5. In applying this Article, paragraph 8 of Article 10 (Dividends), paragraph 5 of Article 11 (Interest), paragraph 5 of Article 12 (Royalties), paragraph 3 of Article 13 (Gains) and paragraph 3 of Article 21 (Other Income), any income, profit or gain attributable to a permanent establishment during its existence is taxable in the Contracting State where such permanent establishment is situated even if the payments are deferred until such permanent establishment has ceased to exist.</p>
<p>Comments Article 7(5) of the US Model containing specific provision relating to attribution of certain specified incomes to PE even if the payments are deferred until such PE has ceased to exist, is absent in the OECD Model and the UN Model.</p>			

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
8	INTERNATIOANAL SHIPPING, AND AIR TRANSPORT	INTERNATIOANAL SHIPPING, AND AIR TRANSPORT	SHIPPING AND AIR TRANSPORT
		Alternative – A	
1	Profits from the operation of ships or aircraft in international traffic shall be taxable only in that State.	Profits from the operation of ships or aircraft in international traffic shall be taxable only in that State	Profits <i>of an enterprise of a Contracting State</i> from the operation of ships or aircraft in international traffic shall be taxable only in that State.
<p>Comments</p> <p>UN & OECD Models: The Article 8 of the UN Model contains two alternatives, namely ‘Alternative A’ containing 2 paras and ‘Alternative B’ containing 3 paras. Effectively, Para 8A(1) deals with profits from the operation of ships or aircraft in International traffic. In Alternative B, the same Para 8A(1) has been bifurcated in to two Paras i.e. 8B(1) dealing with profits from the operation of aircraft in International traffic and 8B(2) dealing with profits from the operation of ships in International traffic . Other paras of Alternative A are similar to Alternative B.</p> <p>Article 8(1) of the OECD Model dealing with ships and aircrafts is identical to Article 8A(1) of the UN Model also dealing with ships and aircrafts. However, Article 8B(2) dealing with profits from the operation of ships in International traffic also encompasses the concept of taxation of profit of shipping activities arising from operations which are more than casual and also incorporates basis of allocation of the overall net profits derived by the enterprise, between the two states, which are absent in Article 8(1) of the OECD Model and Article 8A(1) of the UN Model.</p> <p>US & OECD Models: Article 8(1) of the OECD Model is similar to Article 8(1) of the US Model with changes, which have been highlighted in the US Model column.</p>			
			2. For purposes of this Article, profits from the operation of ships or aircraft include, but are

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>not limited to:</i></p> <ul style="list-style-type: none"> a) <i>profits from the rental of ships or aircraft on a full (time or voyage) basis;</i> b) <i>profits from the rental on a bareboat basis of ships or aircraft if the rental income is incidental to profits from the operation of ships or aircraft in international traffic; and</i> c) <i>profits from the rental on a bareboat basis of ships or aircraft if such ships or aircraft are operated in international traffic by the lessee.</i> <p><i>Profits derived by an enterprise from the inland transport of property or passengers within either Contracting State shall be treated as profits from the operation of ships or aircraft in international traffic if such transport is undertaken as part of international traffic.</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
<p>Comments US Model and OECD Models/UN Models: Article 8(2) of the US Model are absent in OECD and UN Models</p>			
			<p>3. Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) shall be taxable only in that Contracting State, except to the extent that those containers are used for transport solely between places within the other Contracting State.</p>
<p>Comments Article 8(3) of the US Model relating to taxability of use, maintenance, or rental of containers, is absent in the OECD and the UN Models.</p>			
2	The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.	The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.	The provisions of paragraphs 1 and 3 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.
<p>Comments UN & OECD Models: Article 8(2) of the OECD Model is identical to Article 8A(2) and 8B(3) of the UN Model. US & OECD Models: Article 8(4) of the US Model is similar to Article 8(2) of the OECD</p>			

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
Model with minor difference, which has been highlighted in US Model column.			
	Alternate B – NON-EXISTENT	Alternate B	Alternate B – NON-EXISTENT
1	Alternate B (UN Model) Profits of an enterprise of a Contracting State from the operation of aircraft in international traffic shall be taxable only in that State.		
2	Profits of an enterprise of a Contracting State from the operation of ships in international traffic shall be taxable only in that State unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.)		
3	The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.		
Comments			
Both the OECD and US Models do not contain Alternative B, as contained in the UN Model.			
9	ASSOCIATED ENTERPRISES	ASSOCIATED ENTERPRISES	ASSOCIATED ENTERPRISES
1	Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or	Where: (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b) the same persons participate directly or	Where: a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or b) the same persons participate directly or

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
	indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.	indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.	indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then any profits that, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
<p>Comments UN, US & OECD Models: Article 9(1) of the OECD Model is identical to Article 9(1) of the UN and US Models.</p>			
2	Where a Contracting State includes in the profits of an enterprise	Where a Contracting State includes in the profits of an enterprise	Where a Contracting State includes in the profits of an enterprise of that State,

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	<p>of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.</p>	<p>of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.</p>	<p>and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the other Contracting State agrees that the profits so included are profits that would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those that would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.</p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
Comments UN, US & OECD Models: Article 9(2) of the OECD Model is identical to Article 9(2) of the UN and US Models.			
		3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.	
Comments Article 9(3) of the UN Model, which is in the nature of a non-tax penalty, is absent in the OECD and US Models.			
10	DIVIDENDS	DIVIDENDS	DIVIDENDS
1	Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.	Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.	Dividends paid by a company that is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
Comments UN, US & OECD Models: Article 10(1) of the OECD Model is identical to Article 10(1) of the UN and US Models.			

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
2	<p>However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:</p> <p>(a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds</p>	<p>However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:</p> <p>(a) ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate</p>	<p>However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the</p> <p>dividends are beneficially owned by a resident of the other Contracting State, except as otherwise provided, the tax so charged shall not exceed:</p> <p>(a) 5 percent of the gross amount of the dividends if, for the twelve-month period ending on the date on which the entitlement to the dividends is determined:</p> <p>i) The beneficial owner has been a company that was a resident of the other Contracting State or of a qualifying third state. The term “qualifying third state” means a state that has in effect a comprehensive convention for the avoidance of double taxation with the Contracting State of the company paying the dividends that would have</p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
	<p>the shares or that pays the dividend);</p> <p>(b) 15 per cent of the gross amount of the dividends in all other cases.</p> <p>The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.</p> <p>This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.</p>	<p>reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);</p> <p>(b) <i>per cent (the percentage is to be established through bilateral negotiations)</i> of the gross amount of the dividends in all other cases.</p> <p>The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.</p> <p>This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.</p>	<p>allowed the beneficial owner to benefit from a rate of tax on dividends that is less than or equal to 5 percent; and</p> <p>ii) at least 10 percent of the aggregate vote and value of the shares of the payor of the dividends was owned directly by the beneficial owner or a qualifying predecessor owner. The term “qualifying predecessor owner” means a company from which the beneficial owner acquired the shares of the payor of the dividends, but only if such company was, at the time the shares were acquired, a connected person with respect to the beneficial owner of the dividend, and a resident of a state that has in effect a comprehensive convention for the avoidance of double taxation with the Contracting State of the company paying the dividends that would have allowed such company to benefit from a rate of tax on dividends that is less than or equal to 5 percent. For this purpose, a</p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p>company that is a resident of a Contracting State shall be considered to own directly the shares owned by an entity that:</p> <p>A) is considered fiscally transparent under the laws of that Contracting State; and</p> <p>B) is not a resident of the other Contracting State of which the company paying the dividends is a resident; in proportion to the company's ownership interest in that entity;</p> <p>(b) 15 percent of the gross amount of the dividends in all other cases.</p> <p>This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.</p>
			<p>3. Notwithstanding paragraph 2, dividends shall not be taxed in the Contracting State of which the company paying the dividends is a resident if:</p> <p>a) the beneficial owner of the dividends is a pension fund that is a resident of the other Contracting</p>

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			<p><i>State; and</i></p> <p><i>b) such dividends are not derived from the carrying on of a trade or business by the pension fund or through an associated enterprise.</i></p>
			<p><i>4. a) Subparagraph a) of paragraph 2 shall not apply in the case of dividends paid by a U.S. Regulated Investment Company (RIC) or a U.S. Real Estate Investment Trust (REIT). In the case of dividends paid by a RIC, subparagraph b) of paragraph 2 and paragraph 3 shall apply. In the case of dividends paid by a REIT, subparagraph b) of paragraph 2 and paragraph 3 shall apply only if:</i></p> <p><i>i) the beneficial owner of the dividends is an individual or pension fund, in either case holding an interest of not more than 10</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>percent in the REIT;</i></p> <p><i>ii) the dividends are paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5 percent of any class of the REIT's stock; or</i></p> <p><i>iii) the beneficial owner of the dividends is a person holding an interest of not more than 10 percent in the REIT and the REIT is diversified.</i></p> <p><i>b) For purposes of this paragraph, a REIT shall be "diversified" if the value of no single interest in real property exceeds 10 percent of its total interests in real property. For the purposes of this rule, foreclosure property shall not be</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>considered an interest in real property. Where a REIT holds an interest in a partnership, it shall be treated as owning directly a proportion of the partnership's interests in real property corresponding to its interest in the partnership.</i></p>
<p>Comments UN & OECD Models: 10(2) is identical and similar to the US Model. UN, US & OECD Models: Article 10(3) and 10(4) of the US Model are absent in the OECD and UN Models.</p>			
			<p><i>5. In the case of the United States, notwithstanding the provisions of paragraph 2 of this Article, dividends paid by an expatriated entity and beneficially owned by a company resident in _____ that is a connected person with respect to such expatriated entity may be taxed in accordance with the law of the United States for a period of ten years beginning on the date on which the acquisition of the domestic entity is</i></p>

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			<p><i>completed. For purposes of applying this paragraph:</i></p> <ul style="list-style-type: none"><i>a) no effect shall be given to any amendment to section 7874 of the Internal Revenue Code after the date of signature of this Convention; and</i><i>b) no entity shall be treated as an expatriated entity that:</i><ul style="list-style-type: none"><i>i) is a connected person with respect to the domestic entity immediately after the date on which the acquisition of the domestic entity is completed; and</i><i>ii) prior to that date, was never a connected person with respect to the domestic entity.</i> <p><i>However, an entity described in the preceding sentence shall become an expatriated entity if, subsequent to the date on which the acquisition of the domestic entity is completed, the entity joins in filing a U.S. consolidated return with either the domestic entity or another entity that was a connected person with respect to the domestic entity immediately prior to</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<i>the date on which the acquisition of the domestic entity was completed.</i>
			<p>6. Notwithstanding the provisions of paragraphs 1 and 2 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) regarding a dividend, if such company fails to satisfy the criteria of that paragraph solely by reason of:</p> <p>a) the requirement in subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention; or</p> <p>b) the requirement in clause (ii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) that a person entitled to benefits under paragraph 5 of Article 22 (Limitation on Benefits) would be entitled to a rate of tax with respect to the dividend that is less than or equal to the rate applicable under paragraph 2 of this Article; such company may be taxed in the Contracting State of which the company paying the</p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>dividends is a resident and according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention (notwithstanding the requirements referred to in subparagraphs (a) and (b) of this paragraph) would have been entitled if such persons had received the dividend directly.</i></p> <p><i>For purposes of this paragraph,</i></p> <p><i>(i) such persons' indirect ownership of the shares of the company paying the dividends shall be treated as direct ownership, and</i></p> <p><i>(ii) a person described in clause</i></p> <p><i>(iii) of 21 subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<i>dividends.</i>
3	The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.	3. The term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.	<i>7. For purposes of this Article, the term "dividends" means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subject to the same taxation treatment as income from shares under the laws of the Contracting State of which the company making the distribution is a resident. The term does not include distributions that are treated as gain under the laws of the Contracting State of which the company making the distribution is a resident. In such case, the provisions of Article 13 (Gains) shall apply.</i>
Comments			
UN & OECD Models: Article 10(3) of the OECD Model is identically worded as Article 10(3) of the UN Model.			
4	The provisions of paragraphs 1 and 2	4. The provisions of paragraphs 1 and 2	8. The provisions of paragraphs 1 through 6 of

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	shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.	shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein , and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base . In such case the provisions of article 7 or article 14, as the case may be , shall apply.	this Article shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply.
<p>Comments</p> <p>UN & OECD Models: Article 10(4) of the OECD model differs from the UN Model insofar as the OECD Model does not refer to a “fixed base”.</p> <p>US & OECD Models Article 10(8) of the US Model is similar to Article 10(4) of the OECD Model.</p>			
5	Where a company which is a resident of a	5. Where a company which is a resident of a	9. A Contracting State may not impose any

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	<p>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 insofar as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.</p>	<p>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 in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.</p>	<p><i>tax on dividends paid by a resident of the other State, except insofar as the dividends are paid to a resident of the first-mentioned State or the dividends are attributable to a permanent establishment, nor may it impose tax on a corporation's undistributed profits, except as provided in paragraph 10, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State.</i></p>
<p>Comments UN & OECD Models: Article 10(5) of the OECD Model and Article 10(5) UN Model are identical.</p>			

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
US & OECD Models Article 10(9) of the US Model and Article 10(5) of the OECD Model are similar with differences in language which are highlighted in US Model column.			
			10. (a) A company that is a resident of one of the States and that has a permanent establishment in the other State or that is subject to tax in the other State on a net basis on its income that may be taxed in the other State under Article 6 (Income from Real Property) or under paragraph 1 of Article 13 (Gains) may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention.
			(b) Such tax, however, may be imposed: i) on only the portion of the business profits of the company attributable to the permanent establishment and the portion of the income referred to in subparagraph a) that is subject to tax under Article 6 or under paragraph 1 of Article

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>13 that, in the case of the United States, represents the dividend equivalent amount of such profits or income and, in the case of -----, is an amount that is analogous to the dividend equivalent amount; and</i></p> <p><i>ii) at a rate not in excess of the rate specified in paragraph 2 a).</i></p>
<p>Comments US, UN & OECD Models: Article 10(10) of the US Model dealing with branch profit tax, is absent in the OECD and UN Models.</p>			
11	INTEREST	INTEREST	INTEREST
1	Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.	Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.	Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State.
<p>Comments UN & OECD Models: Article 11(1) of the OECD Model is identical to Article 11(1) of the UN Model. US & OECD Models Article 11(1) of the US Model and Article 11(1) of the OECD Model are similar with minor differences in language which are highlighted in US Model column.</p>			
2	However, interest arising in a Contracting State may also be taxed in that State according	However, interest arising in a Contracting State may also be taxed in that State and according to the laws of	Notwithstanding the provisions of paragraph 1 of this Article: a) interest arising in that is determined with

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	<p>to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.</p>	<p>that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent [the percentage is to be established through bilateral negotiations] of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.</p>	<p><i>reference to receipts, sales, income, profits or other cash flow of the debtor or a connected person with respect to the debtor, to any change in the value of any property of the debtor or a connected person with respect to the debtor or to any dividend, partnership distribution or similar payment made by the debtor or a connected person with respect to the debtor may be taxed in _____, and according to the laws of _____, but if the beneficial owner is a resident of the United States, the interest may be taxed at a rate not exceeding 15 percent of the gross amount of the interest;</i></p> <p><i>b) interest arising in the United States that is contingent interest of a type that does not qualify as portfolio interest under the law of the United States may be taxed by the United States, but if the beneficial owner is a resident of _____,</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>the interest may be taxed at a rate not exceeding 15 percent of the gross amount of the interest;</i></p> <p><i>c) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payor of the interest may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to such interest in its Contracting State of residence;</i></p> <p><i>d) in the case of the United States, interest paid by an expatriated entity and beneficially owned by a company resident in _____ that is a connected person with respect to such expatriated entity may be taxed in accordance with the law of the United States for a period of ten years beginning on the date on which the acquisition of the domestic entity is completed. For purposes</i></p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>of applying this paragraph:</i></p> <p><i>i) no effect shall be given to any amendment to section 7874 of the Internal Revenue Code after the date of signature of this Convention; and</i></p> <p><i>ii) no entity shall be treated as an expatriated entity that:</i></p> <p><i>A) is a connected person with respect to the domestic entity immediately after the date on which the acquisition of the domestic entity is completed; and</i></p> <p><i>24 B) prior to that date, was never a connected person with respect to the domestic entity.</i></p> <p><i>However, an entity described in the preceding sentence shall become an expatriated entity if, subsequent to the date on which the acquisition of the domestic entity is completed, the entity joins in filing a U.S. consolidated return with either the domestic entity or another entity that was a connected</i></p>

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			<p><i>person with respect to the domestic entity immediately prior to the date on which the acquisition of the domestic entity was completed;</i></p> <p><i>e) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payer of the interest may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits, at any time during the taxable year in which the interest is paid, from notional deductions with respect to amounts that the Contracting State of which the beneficial owner is resident treats as equity;</i></p> <p><i>f) interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is entitled to the benefits of this Article only by reason of paragraph 5 of Article 22 (Limitation on</i></p>

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			<p><i>Benefits) may be taxed in the first-mentioned Contracting State, but the tax so charged shall not exceed 10 percent of the gross amount of the interest; and</i></p> <p><i>g) Interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit may be taxed by each Contracting State in accordance with its domestic law.</i></p>
<p>Comments</p> <p>UN & OECD Models: Article 11(2) of the OECD Model differs from Article 11(2) of the UN Model to the extent that it provides that the tax in State S “shall not exceed 10% of the gross amount of interest”, but the UN Model leaves this percentage to be established through bilateral negotiations and the US Model limits the tax rate to 15% of the gross amount of interest.</p> <p>US & OECD Models Article 11(2) of the US Model differs in language and contents, which are highlighted in US Model column.</p>			
			<p>3. Notwithstanding the provisions of paragraph 1 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) of this Convention regarding a payment of interest, if such company fails to satisfy the criteria</p>

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>of that paragraph solely by reason of:</i></p> <p><i>a) the requirement in sub-clause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention; or</i></p> <p><i>b) the requirement in clause (ii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) that a person entitled to benefits under paragraph 5 of Article 22 (Limitation on Benefits) would be entitled to a rate of tax with respect to the interest that is less than or equal to the rate applicable under paragraph 2 of this Article; such company may be taxed by the Contracting State in which the interest arises according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits)</i></p>

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			<p><i>of this Convention (notwithstanding the requirements referred to in subparagraphs (a) and (b) of this paragraph) would have been entitled if such persons had received the interest directly. For purposes of this paragraph, a person described in clause (iii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the interest.</i></p>
3	<p>The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures,</p>	<p>The term "interest" as used in this article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures,</p>	<p>4. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums or prizes attaching to such</p>

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	including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.	including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this article.	securities, bonds or debentures, and all other income that is subjected to the same taxation treatment as income from money lent by the taxation law of the Contracting State in which the income arises. Income dealt with in Article 10 (Dividends) and penalty charges for late payment shall not be regarded as interest for the purposes of this Convention.
4	The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such	4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the	5. The provisions of paragraphs 1 through 3 of this Article shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply.

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	case the provisions of Article 7 shall apply.	interest is paid is effectively connected with (a) such permanent establishment <i>or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7</i> . In such cases the provisions of article 7 <i>or article 14, as the case may be</i> , shall apply.		
Comments				
OECD, UN & US Models: Article 11(4) of the OECD and US Model differs from Article 11(4) of the UN Model as follows:				
Sr. No.	Subject	Article 11(4) of OECD Model	Article 11(4) of UN Model	Article 11(4) of US Model
1	Fixed Base	Does not refer to a “fixed base”	Refers to a “Fixed base”	Does not refer to a “fixed base”.
2	Reference to “limited force of attraction” rule in Article 7(1)	Does not refer to the FOA rule	Refers to business activities in the source country of the same or similar kind as those effected through the PE [see Article 7(1)(c)]	Does not refer to the FOA rule.
5	Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State.	5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where,	6. For purposes of this Article, interest shall be deemed to arise in a Contracting State when the payor is a resident of	

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	<p>Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.</p>	<p>however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.</p>	<p>that Contracting State. Where, however, the person paying the interest, whether a resident of a Contracting State or not, has in a Contracting State a permanent establishment or derives profits that are taxable on a net basis in a Contracting State under paragraph 5 of Article 6 (Income from Real Property (Immovable Property)) or paragraph 1 of Article 13 (Gains), and such interest is borne by such permanent establishment or allocable to such profits, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment is situated or from which such profits are derived.</p>
<p>Comments UN & OECD Models: Article 11(5) of the OECD Model does not differ from Article 11(5) of the UN Model, except that the OECD Model does not refer to a fixed base. Article 11(5) of the OECD and UN Model dealing with source rule relating to taxation of interest and indebtedness on which interest is paid relating to a PE or Fixed base is similar to Article 11(6) of US Model having difference in language.</p>			
			<p>7. The excess, if any, of the amount of interest allocable to the profits of a company resident in a Contracting State that are:</p>

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			<p>a) attributable to a permanent establishment in the other Contracting State (including gains under paragraph 3 of Article 13 (Gains)); or</p> <p>b) subject to tax in the other Contracting State under Article 6 (Income from Real Property (Immovable Property)) or paragraph 1 of Article 13 (Gains);</p> <p>over the interest paid by that permanent establishment, or in the case of profits subject to tax under Article 6 (Income from Real Property (Immovable Property)) or paragraph 1 of Article 13 (Gains), over the interest paid by that company, shall be deemed to arise in that other Contracting State and to be beneficially owned by a resident of the first-mentioned Contracting State. The tax imposed under this Article on such interest shall not exceed the rates provided in paragraphs 1 through 3 of this Article.</p>
6	Where, by reason of a special relationship between the payer and	6. Where, by reason of a special relationship between the payer and	8. Where, by reason of a special relationship between the payor and the

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	the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount that would have been agreed upon by the payor and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.
Comments			
UN & OECD Models: Article 11(6) of the OECD Model is identical to Article 11(6) of the UN Model.			
OECD and US Models: Article 11(8) of the US Model is almost similar to Article 11(6) of the OECD Model.			
12	ROYALTIES	ROYALTIES	ROYALTIES
1	Royalties arising in a Contracting State and beneficially owned	1. Royalties arising in a Contracting State and paid to a resident of the	Royalties arising in a Contracting State and beneficially owned by a

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	by a resident of the other Contracting State shall be taxable only in that other State.	other Contracting State <i>may be taxed in</i> that other State.	resident of the other Contracting State shall be taxable only in that other Contracting State.
		2. However, royalties may also be taxed in that state and according to the laws of that state but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.	
<p>Comments UN & OECD Models: As per Article 12(1) of the OECD Model, royalties arising in State S and beneficially owned by resident of the State R are taxable only in State R. Thus, unlike the UN Model, royalties are not taxable in State S. The exemption in State S is not conditional upon (a) the royalties being subject to tax in State R; and (b) Compliance with any formality (e.g. submission of an exemption certificate of the Finance Ministry of State S).</p>			

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<p>A provision corresponding to Article 12(2) of the UN Model is absent in the OECD Model since the OECD Model does not allow sharing of taxing rights by contracting States. However, the OECD Model does require that the royalties should be beneficially owned by a resident of State R.</p> <p>OECD and US Models: Article 12(1) of the US Model is similar to Article 12(1) of the OECD Model,</p>			
			<p>2. Notwithstanding the provisions of paragraph 1 of this Article:</p> <p>a) a royalty arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payor of the royalty may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to the royalty in its Contracting State of residence; and</p> <p>b) in the case of the United States, royalties paid by an expatriated entity and beneficially owned by a company resident in _____ that is a connected person with respect to such expatriated entity may be taxed in accordance with the law of the United States for a period of ten years beginning on the date on</p>

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			<p>which the acquisition of the domestic entity is completed. For purposes of applying this paragraph:</p> <ul style="list-style-type: none">i) no effect shall be given to any amendment to section 7874 of the Internal Revenue Code after the date of signature of this Convention; andii) no entity shall be treated as an expatriated entity that:<ul style="list-style-type: none">A) is a connected person with respect to the domestic entity immediately after the date on which the acquisition of the domestic entity is completed; andB) prior to that date, was never a connected person with respect to the domestic entity. <p>However, an entity described in the preceding sentence shall become an expatriated entity if, subsequent to the date on which the acquisition of the domestic entity is completed, the entity joins in filing a U.S. consolidated return with either the domestic entity or another entity that was a connected person with</p>

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			respect to the domestic entity immediately prior to the date on which the acquisition of the domestic entity was completed.
			3. Notwithstanding the provisions of paragraph 1 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 22 (Limitation on Benefits) of this Convention regarding a royalty, if such company fails to satisfy the criteria of that paragraph solely by reason of the requirement in subclause (B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention, such company may be taxed in the Contracting State of which the royalty arises and according to the laws of that Contracting State, except that the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) of this Convention (notwithstanding the requirement of sub-clause

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			(B) of clause (i) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits)) would have been entitled if such persons had received the royalty directly. For purposes of this paragraph, a person described in clause (iii) of subparagraph (e) of paragraph 7 of Article 22 (Limitation on Benefits) shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the royalties.
2	The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning	3. The term "royalties" as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting , any patent, trade mark, design or model, plan,	4. The term "royalties" as used in this Article means: a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including cinematographic films) , any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific

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	industrial, commercial or scientific experience.	secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.	experience; and
<p>Comments</p> <p>UN & OECD Models: Article 12(2) of the OECD Model is identical to Article 12(3) of the UN Model except that the OECD Model specifically excludes the following from “royalties”:</p> <ul style="list-style-type: none"> • Rentals for “films or tapes used for radio or television broadcasting”; • Equipment rentals [In certain situations, the lease rental for industrial, commercial or scientific equipment may include an element of “royalty” (e.g. for use of a patent). In such cases, the lease rent may be treated as a “royalty” as per Article 12(2) of the OECD Model to the extent it could be attributed to the use of the patent]. <p>Such rentals are taxable under Article 7 or 21 of the OECD Model.</p> <p>US & OECD Models: Article 12(4) of the US Model is similar to Article 12(1) of the OECD Model, with minor difference in language having the same meaning and implications. Explanation 2 to Section 9(1)(vi) of the Income-tax Act, 1961 defines the term ‘royalty’ in wide terms. The definition of Royalty in Article 12(3) of the UN Model, is a truncated one and is not para materia with the definition of royalty in Explanation 2 to Section 9(1)(vi). The distinguishing features in the two definitions are that (a) whereas under section 9(1)(vi) any consideration for the transfer of all or any rights in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property falls within its definition, under article 12(3) of the UN Model, mainly the payment for use of or right to use such assets would fall within the definition of ‘royalties’.</p>			
3	The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State,	4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a	5. The provisions of paragraphs 1 through 3 of this Article shall not apply if the beneficial owner of the royalties, being a resident of a Contracting

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	<p>carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.</p>	<p>Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, <i>or performs in that other State independent personal services from a fixed base situated therein,</i> and the right or property in respect of which the royalties are paid is effectively connected with <i>(a)</i> such permanent establishment <i>or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7.</i> In such cases the provisions of article 7 <i>or article 14, as the case may be,</i> shall apply.</p>	<p>State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply.</p>
		<p><i>5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he</i></p>	

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		<p><i>is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.</i></p>	
<p>Comments UN & OECD Models: Article 12(3) of the OECD Model differs from Article 12(4) of the UN Model in the following two respects: (a) The OECD Model does not include reference to Article 14 (Independent Personal Services) since the OECD model has deleted Article 14; and (b) It does not include reference to Article 7(1)(b)/7(1)(c) (FOA rule) since such a provision is present only in the UN Model. A provision corresponding to Article 12(5) of the UN Model is not present in Article 12 of the OECD Model since exemption for royalties in State S renders the “source rule” irrelevant. US & OECD Models: Article 12(5) of the US Model is similar to Article 12(3) of the OECD Model, with minor difference in language having the same meaning and implications.</p>			
			<p>6. Royalties shall be deemed to arise in a Contracting State when</p>

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			they are in consideration for the use of, or the right to use, property, information or experience in that Contracting State.
4	Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

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<p>Comments</p> <p>UN & OECD Models: Article 12(4) of the OECD Model is identical to Article 12(6) of the UN Model.</p> <p>US & OECD Models: Article 12(7) of the US Model is similar to Article 12(4) of the OECD Model, with minor difference in language having the same meaning and implications.</p> <p>Fees for Technical Services [FTS]: OECD and US Model conventions do not contain a specific article for FTS and hence, in its absence, taxability of FTS has to be considered either under Article 7 or Article 14 or Article 21, depending upon the facts. However, UN Model have a specific provision for taxing FTS.</p>			
12A	Fees for Technical Services	Fees for Technical Services	Fees for Technical Services
		<p>1. Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.</p> <p>2. However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the</p>	

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		<p>other Contracting State, the tax so charged shall not exceed ___ per cent [the percentage is to be established through bilateral negotiations] of the gross amount of the fees.]</p> <p>3. The term “fees for technical services” as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made:</p> <p>(a) to an employee of the person making the payment;</p> <p>(b) for teaching in an educational institution or for teaching by an educational institution;</p> <p>or</p> <p>(c) by an individual for services for the personal use of an individual.</p> <p>4. The provisions of</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with:</p> <p>(a) such permanent establishment or fixed base, or</p> <p>(b) business activities referred to in (c) of paragraph 1 of Article 7.</p> <p>In such cases the provisions of Article 7 or Article 14, as the</p>	

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		<p>case may be, shall apply</p> <p>5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.</p> <p>6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and</p>	

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		<p>carries on business in the other Contracting State through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State and such fees are borne by that permanent establishment or fixed base.</p> <p>7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only</p>	

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		to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	
<p>Comments: Article 12A was added to the United Nations Model Convention in 2017 to allow a Contracting State to tax fees for certain technical services paid to a resident of the other Contracting State on a gross basis at a rate to be negotiated by the Contracting States. There is no separate Article dealing with Fees for Technical Services in either OECD or US model Convention.</p>			
12B		Income from automated digital services	
		<p>1. Income from automated digital services arising in a Contracting State, underlying payments for which are made to a resident of the other Contracting State, may be taxed in that other State.</p> <p>2. However, subject to the provisions of Article 8 and notwithstanding the provisions of Article</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>14, income from automated digital services arising in a Contracting State may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the income is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent [the percentage is to be established through bilateral negotiations] of the gross amount of the payments underlying the income from automated digital services.</p> <p>3. The provisions of paragraph 2 shall not apply if the beneficial owner of the income from automated digital services, being a resident of a Contracting State, requests the other Contracting State where such income</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>arises, to subject its qualified profits from automated digital services for the fiscal year concerned to taxation at the tax rate provided for in the domestic laws of that State. If the beneficial owner so requests, subject to the provisions of Article 8 and notwithstanding the provisions of Article 14, the taxation by that Contracting State shall be carried out accordingly. For the purposes of this paragraph, the qualified profits shall be 30 per cent of the amount resulting from applying the profitability ratio of that beneficial owner's automated digital services business segment to the gross annual revenue from automated digital services derived from the Contracting State where such income arises. Where</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>segmental accounts are not maintained by the beneficial owner, the overall profitability ratio of the beneficial owner will be applied to determine qualified profits. However, where the beneficial owner belongs to a multinational enterprise group, the profitability ratio to be applied shall be that of the business segment of the group relating to the income covered by this Article, or of the group as a whole in case segmental accounts are not maintained by the group, provided such profitability ratio of the multinational enterprise group is higher than the aforesaid profitability ratio of the beneficial owner. Where the segmental profitability ratio or, as the case may be, the overall profitability ratio of the multinational enterprise group to</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>which the beneficial owner belongs is not available to the Contracting State in which the income from automated digital services arises, the provisions of this paragraph shall not apply; in such a case, the provisions of paragraph 2 shall apply.</p> <p>4. For the purposes of paragraph 3, “multinational enterprise group” means any “group” that includes two or more enterprises, the tax residence for which is in different jurisdictions. Further, for the purposes of paragraph 3, the term “group” means a collection of enterprises related through ownership or control such that it is either required to prepare Consolidated Financial Statements</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public stock exchange.</p> <p>5. The term “automated digital services” as used in this Article means any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider.</p> <p>6. The term “automated digital services” includes especially:</p> <ul style="list-style-type: none"> (a) online advertising services; (b) supply of user data; (c) online search engines; (d) online intermediation 	

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>platform services; (e) social media platforms; (f) digital content services; (g) online gaming; (h) cloud computing services; and (i) standardized online teaching services.</p> <p>7. The provisions of this Article shall not apply if the payments underlying the income from automated digital services qualify as “royalties” or “fees for technical services” under Article 12 or Article 12A as the case may be.</p> <p>8. The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the income from automated digital services, being a resident of a Contracting State, carries on business in the other Contracting State in which the</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>income from automated digital services arises through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the income from automated digital services is effectively connected with:</p> <p>(a) such permanent establishment or fixed base, or</p> <p>(b) business activities referred to in subparagraph (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.</p> <p>9. For the purposes of this Article and subject to paragraph 10, income from automated digital services shall be deemed to arise in a Contracting State if</p>	

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>the underlying payments for the income from automated digital services are made by a resident of that State or if the person making the underlying payments for the automated digital services, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to make the payments was incurred, and such payments are borne by the permanent establishment or fixed base.</p> <p>10. For the purposes of this Article, income from automated digital services shall be deemed not to arise in a Contracting State if the underlying payments for the income from</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>automated digital services are made by a resident of that State which carries on business in the other Contracting State through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State and such underlying payments towards automated digital services are borne by that permanent establishment or fixed base.</p> <p>11. Where, by reason of a special relationship between the payer and the beneficial owner of the income from automated digital services or between both of them and some other person, the amount of the payments underlying such income, having regard to the services</p>	

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments underlying such income from automated digital services shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.</p>	
<p>Comments: Article 12B was added to the United Nations Model Convention in 2021. There is no separate Article dealing with the same in either OECD or US Model Convention.</p>			
13	CAPITAL GAINS	CAPITAL GAINS	GAINS
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	Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the	Gains derived by a resident of a Contracting State from the alienation of real property (immovable property) situated in the other Contracting State may be taxed in that other

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	other Contracting State may be taxed in that other State.	other Contracting State may be taxed in that other State.	Contracting State.
			<p>2. For the purposes of this Article the term "real property" (immovable property) situated in the other Contracting State" shall include:</p> <p>a) real property (immovable property) referred to in Article 6 (Income from Real Property (immovable property));</p> <p>b) where that other State is the United States, a United States real property interest; and</p> <p>c) where that other State is -----,</p> <p>i) shares, including rights to acquire shares, other than shares in which there is regular trading on a stock exchange, deriving 50 percent or more of their value directly or indirectly from real property referred to in subparagraph (a) of this paragraph situated in _____; and</p> <p>ii) an interest in a partnership or trust to the</p>

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			extent that the assets of the partnership or trust consist of real property situated in _____, or of shares referred to in clause (i) of this subparagraph.
<p>Comments</p> <p>UN & OECD Models: Article 13(1) of the OECD Model is identically worded as Article 13(1) in the UN Model.</p> <p>US & OECD Models: Article 13(1) of the US Model is similar to Article 13(1) of the OECD Model, with minor difference in language, which is highlighted in US Model column, having the same meaning and implications.</p> <p>In addition, Article 13(2) of the US Model defines and explains the scope of the term real property (immovable property) situated in the other Contracting State, which is similar in intent to the provisions of Article 13(4) of the OECD and UN Models.</p>			
2	Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.	2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services , including	3. Gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

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		such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base , may be taxed in that other State.	
<p>Comments</p> <p>UN & OECD Models: Article 13(2) of the OECD Model does not have references to fixed base or IPS, consequent to the deletion of Article 14 in the OECD Model.</p> <p>US & OECD Models: Article 13(3) of the US Model is similar to Article 13(2) of the OECD Model, with minor difference in language, which is highlighted in US Model column, having the same meaning and implications.</p>			
3	3. Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.	3. Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State	4. Gains <i>derived by an enterprise of a Contracting State</i> from the alienation of ships or aircraft operated or used in international traffic or personal property pertaining to the operation or use of such ships or aircraft shall be taxable only in that State.
			5. Gains derived by an enterprise of a Contracting State from the <i>alienation of containers (including trailers, barges and related equipment for the</i>

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
			<p><i>transport of containers</i>) used for the transport of goods or merchandise shall be taxable only in that State, unless those containers are used for transport solely between places within the other Contracting State.</p>
<p>Comments UN & OECD Models: Article 13(3) constitutes is an exception to the rule in Article 13 (2). Article 13(3) of the OECD Model is identically worded as Article 13(3) of the UN Model. US & OECD Models: Article 13(4) of the US Model is similar to Article 13(3) of the OECD Model, with differences in language, which is highlighted in US Model column. In addition, Article 13(5) of the US Model specifically covers alienation of containers (including trailers, barges and related equipment for the transport of containers), which Article is absent in the OECD and UN Models.</p>			
4	Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or	Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from	

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	indirectly from immovable property, as defined in Article 6, situated in that other State.	immovable property, as defined in Article 6, situated in that other State.	
		5. Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least ___ percent (the percentage is to be established through bilateral negotiations) of the capital of that company.	
<p>Comments UN & OECD Models: Article 13(4) of the OECD Model is identical to Article 13(4) in the UN Model US, UN & OECD Models: Article 13(4) of the OECD and UN Models are similar in intent to Article 13(2) of the US Model, with differences in language.</p>			

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
Article 13(5) of the UN Model is absent in the OECD and US Models.			
		<p>6. Gains derived by a resident of a Contracting State from the alienation of a right granted under the law of the other Contracting State which allows the use of resources that are naturally present in that other State and that are under the jurisdiction of that other State, may be taxed in that other State.</p>	
		<p>7. Subject to paragraphs 4 and 5, gains derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests of an entity, such as interests in a partnership or trust, may be taxed in the other Contracting State if</p> <p>(a) the alienator, at any time during the</p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p>365 days preceding such alienation, held directly or indirectly at least ___ per cent [the percentage is to be established through bilateral negotiations] of the capital of that company or entity; and</p> <p>(b) at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from</p> <p>(i) a property any gain from which would have been taxable in that other State in accordance with the preceding provisions of this Article if that gain had been derived by a resident of the first-mentioned State from the alienation of that property at that time, or 29 (ii) any combination of property referred to in subdivision (i).</p>	

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
5	Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.	8. Gains from the alienation of any property other than that referred to in paragraphs 1 to 7 shall be taxable only in the Contracting State of which the alienator is a resident.	6. Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident.
			7. Where an individual who, upon ceasing to be a resident (as determined under paragraph 1 of Article 4 (Resident)) of one of the Contracting States, is treated under the taxation law of that Contracting State as having alienated property for its fair market value and is taxed in that Contracting State by reason thereof, the individual may elect to be treated for purposes of taxation in the other Contracting State as if the individual had, immediately before ceasing to be a resident of the first-mentioned Contracting State, alienated and reacquired such property for an amount equal to its fair market value at such time.

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
<p>Comments UN & OECD Models: Article 13(5) of the OECD Model is identical to Article 13(8) of the UN Model except that the words “in paragraphs 1, to 7 ” in the UN Model are replaced by the words “in paragraphs 1,2,3 and 4” in the OECD Model. US & OECD Models: Article 13(6) of the US Model is similar to Article 13(5) of the OECD Model, with minor difference in language, which is highlighted in US Model column, having the same meaning and implications.</p>			
14	Independent Personal Services [Deleted]	Independent Personal Services	Independent Personal Services [Deleted]
1	<p>UN Model Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State: (a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or (b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.</p>		
2	<p>The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.</p>		
<p>Comments The OECD: Article 14 was deleted from the OECD Model on 29-4-2000 on the basis of OECD Report (2000) on “Issues Related to Article 14 of the OECD Model Tax Convention”. The Effect of deletion of Article 14 is that income derived from Professional Services etc., is now dealt with as ‘Business Profits’ under the OECD Model. The US Model: Article 14 which was present in the US Model (1996) has been deleted from the US Model (2006).</p>			

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Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
15	Income from Employment	Dependent Personal Services	Income from Employment [Article 14]
1	Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.	1. Subject to the provisions of articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.	Subject to the provisions of Articles 15 (Directors' Fees) , 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) and 19 (Government Service) , salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that Contracting State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other Contracting State.
<p>Comments</p> <p>UN & OECD Models: Article 15(1) of the OECD Model is identically worded as Article 15(1) of the UN Model.</p> <p>US & OECD Models: Article 15(1) of the US Model is similar to Article 15(1) of the OECD Model, with minor difference in language, which is highlighted in US Model column, having the same meaning and implications.</p>			
2	Notwithstanding the provisions of paragraph 1, remuneration derived	Notwithstanding the provisions of paragraph 1, remuneration derived	Notwithstanding the provisions of paragraph 1 of this Article , remuneration derived by a

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
	<p>by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:</p> <p>(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned, and</p> <p>(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and</p> <p>(c) the remuneration is not borne by a permanent establishment which the employer has in the other State.</p>	<p>by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:</p> <p>(a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and</p> <p>(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and</p> <p>(c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.</p>	<p>resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned Contracting State if:</p> <p>(a) the recipient is present in the other Contracting State for a period or periods not exceeding in the aggregate 183 days for all twelve-month periods commencing or ending in the taxable year concerned;</p> <p>(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other Contracting State; and</p> <p>(c) the remuneration is not borne by a permanent establishment that the employer has in the other Contracting State.</p>
<p>Comments</p> <p>UN & OECD Models: Article 15(2)(a): There are no differences between corresponding provisions of the OECD model and the UN Model.</p> <p>Article 15(2)(b): There are no differences between corresponding provisions of the OECD Model and the UN Model.</p>			

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<p>Article 15(2)(c): Unlike the UN Model, Article 15(2)(c) of the OECD Model does not refer to a fixed base.</p> <p>US & OECD Models: Article 15(2) of the US Model is similar to Article 15(2) of the OECD Model, with minor difference in language, which is highlighted in US Model column, having the same meaning and implications</p>			
3	<p>Notwithstanding the preceding provisions of this Article, remuneration derived <i>by a resident of a Contracting State</i> in respect of an employment, as a <i>member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, other than aboard a ship or aircraft operated solely within the other Contracting State, shall be taxable only in the first-mentioned State.</i></p>	<p>Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, other than aboard a ship or aircraft operated solely within the other Contracting State, shall be taxable only in the first-mentioned State</p>	<p>Notwithstanding the preceding provisions of this Article, remuneration <i>described in paragraph 1 of this Article that is</i> derived by a resident of a Contracting State in respect of an employment as a member of the regular complement of a ship or aircraft <i>operated in international traffic shall be taxable only in that Contracting State.</i></p>
<p>Comments</p> <p>UN & OECD Models: There are no differences between Article 15(3) of the UN Model and the OECD Model.</p> <p>US & OECD Models: Article 14(3) of the US Model is similar to Article 15(3) of the OECD Model, with main difference being exclusion of the words <i>other than aboard a ship or aircraft operated solely within the other Contracting State,</i> in the US Model, which is highlighted in OECD Model column.</p>			

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16	DIRECTORS' FEES	DIRECTORS' FEES & REMUNERATION Of TOP LEVEL MANAGERIAL OFFICERS'	DIRECTORS' FEES [Article 15]
1	Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.	Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.	Directors' fees and other similar payments derived by a resident of a Contracting State for services rendered in the other Contracting State in his capacity as a member of the board of directors of a company that is a resident of the other Contracting State may be taxed in that other Contracting State.
2		<i>Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.</i>	

Comments

UN & OECD Models: Article 16 of the OECD Model is **identically** worded as Article 16(1) of the UN Model.

In the OECD Model, there is no provision corresponding to Article 16(2) of the UN Model.

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<p>Hence, Article 16 of the OECD Model does not apply to remuneration paid to top-level managerial officials. The remuneration for employment-related functions is covered by Article 15 while professional consultancy fees are the subject matter of Article 7.</p> <p>US & OECD Models: Article 15 of the US Model is similar to Article 16 of the OECD Model, with minor differences in the language, which is highlighted in US Model column.</p> <p>Like in the OECD Model, there is no provision corresponding to Article 16(2) of the UN Model, in the US Model.</p>			
17	ENTERTAINERS AND SPORTSPERSONS	ARTISTES AND SPORTSPERSONS	ENTERTAINERS & SPORTSMEN [Article 16]
1	Notwithstanding the provisions of Articles 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from that resident's personal activities as such exercised in the other Contracting State, may be taxed in that other State.	Notwithstanding the provisions of articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a <i>sportsperson</i> , from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.	Notwithstanding the provisions of Article 14 (Income from Employment), income derived by a resident of a Contracting State as an entertainer, such as a theater, motion picture, radio, or television artiste, or a musician, or as a sportsman , from his personal activities as such exercised in the other Contracting State, may be taxed in that other Contracting State, except where the amount of the gross receipts derived by such entertainer or sportsman, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed thirty thousand

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			<i>United States dollars (30,000) or its equivalent in ----- for the taxable year of the payment.</i>
<p>Comments</p> <p>UN & OECD Models: Article 17(1) of the OECD Model differs from Article 17(1) of the UN Model to the extent that the OECD Model does not refer to Article 14.</p> <p>US & OECD Models: Article 16(1) of the US Model relating to Entertainers and Sportsmen is similar to Article 17(1) of the OECD Model, with minor differences in the language, which is highlighted in US Model column. In addition, Article 16(1) of the US Model provides a threshold limit of US\$ 30,000, which is not there in the Article 17(1) of the OECD Model.</p>			
2	Where income in respect of personal activities exercised by an entertainer or a sportsperson acting as such accrues not to the entertainer or sportsperson but to another person, that income may, notwithstanding the provisions of Article 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.	2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.	Where income in respect of activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income, notwithstanding the provisions of Article 14 (Income from Employment), may be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised unless the contract pursuant to which the personal activities are performed allows that other person to designate the individual who is to perform the

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			<i>personal activities.</i>
<p>Comments</p> <p>UN & OECD Models: Article 17(2) of the OECD Model differs from Article 17(2) of the UN Model to the extent that the OECD Model does not refer to Article 14.</p> <p>US & OECD Models: Article 16(2) of the US Model is similar to Article 17(2) of the OECD Model, with differences in the language, which is highlighted in US Model column.</p>			
18	PENSIONS	PENSIONS & SOCIAL SECURITY PAYMENTS	PENSIONS, SOCIAL SECURITY, ANNUITIES, ALIMONY, AND CHILD SUPPORT [Article 17]
		Alternative A	
1.	Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.	1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.	<p>1. a) Pensions and other similar remuneration beneficially owned by a resident of a Contracting State shall be taxable only in that Contracting State.</p> <p>b) Notwithstanding subparagraph a) of this paragraph, the amount of any such pension or remuneration arising in a Contracting State that, when received, would be exempt from taxation in that Contracting State if the beneficial owner were a resident thereof shall be exempt from taxation in the Contracting State of which the beneficial owner is a resident.</p>

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<p>Comments</p> <p>UN & OECD Models: Article 18 of the OECD Model is identical to Article 18A(1) of the UN Model.</p> <p>US & OECD Models: Article 17(1)(a) of the US Model relating to pensions, social security, annuities, alimony, and child support is similar to Article 18 of the OECD Model, with differences in language, which is highlighted in US Model column. Exception carved out in Article 17(1)(b) of US Model is absent in OECD and UN Models.</p>			
		<p>2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.</p>	<p><i>2a) Where an individual who is a resident of a Contracting State is a member or beneficiary of, or participant in, a pension fund established in the other Contracting State, income earned by the pension fund may not be taxed as income of that individual, unless, and then only to the extent that, it is paid to, or for the benefit of, that individual from the pension fund (and not transferred to another pension fund established in that other Contracting State in a transfer that qualifies as a tax-deferred transfer under the laws of that other Contracting State). In such case, the provisions of paragraph 1 of this Article shall</i></p>

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			<p><i>apply.</i></p> <p><i>b) Where a citizen of the United States who is a resident of _____ is a member or beneficiary of, or participant in, a pension fund established in _____, the United States may not tax the income earned by the pension fund as income of the individual unless, and then only to the extent that, it is paid to, or for the benefit of, that individual from the pension fund (and not transferred to another pension fund established in _____ in a transfer that qualifies as a tax-deferred transfer under the laws of _____).</i></p> <p><i>In such case, the provisions of paragraph 1 of this Article, which generally is subject to paragraph 4 of Article 1 (General Scope), shall apply.</i></p>
<p>Comments</p> <p>UN & OECD Models: Article 18A(2) relating to pensions paid and other payments made under a public scheme which is part of the social security system, of the UN Model is absent in OECD Model.</p> <p>US & OECD Models: Article 17(2)(a) and 17(2)(b) of the US Model relating to resident</p>			

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<i>being a member or beneficiary of, or participant in, a pension fund established in the other Contracting State, is absent in the OECD and UN Models.</i>			
			<i>3. Notwithstanding the provisions of paragraph 1 of this Article, payments made by a Contracting State under provisions of the social security or similar legislation of that Contracting State to a resident of the other Contracting State or to a citizen of the United States shall be taxable only in the first-mentioned State.</i>
Comments UN & US Models: Article 17(3) of the US Model relating to payments made under provisions of the social security or similar legislation , is similar to Article 18A(2) of the UN Model, with differences in language, which is highlighted in US Model column.			
Alternative B			
		1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.	
		2. However, such pensions and other similar remuneration	

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		<p>may also be taxed in the other Contracting State if the payment is made by a resident of that other State or if the person paying the pensions or similar remuneration, whether he is a resident of a Contracting State or not, has in that other State a permanent establishment or a fixed base in connection with which the obligation to pay the pensions or similar remuneration was incurred, and such pensions or similar remuneration are borne by such permanent establishment or fixed base.</p>	
		<p>3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local</p>	

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		authority thereof shall be taxable only in that State.	
<p>Comments UN Models: Article 18A(1) and 18A(2) of the UN Model are similar to Article 18B(1) and 18B(3) of the UN Model. Article 18B(2) is absent in Alternative A.</p>			
			<p><i>4. Annuities derived and beneficially owned by an individual resident of a Contracting State shall be taxable only in that Contracting State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during a specified number of years, or for life, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).</i></p>
			<p><i>5. Alimony paid by a resident of a Contracting State to a resident of the other Contracting State shall be taxable only in that other Contracting State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written</i></p>

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			<i>separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the Contracting State of which he is a resident.</i>
			<i>6. Periodic payments, not dealt with in paragraph 5 of this Article, for the support of a child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall be exempt from tax in both Contracting States.</i>
<p>Comments:</p> <p>US Model: Article 17(4) of the US Model relating to Annuities, Article 17(5) relating to Alimony and Article 17(6) relating to periodic payments for the support of a child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, are absent in OECD and UN Models.</p>			

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	PENSION FUNDS – NON-EXISTENT	PENSION FUNDS – NON-EXISTENT	PENSION FUNDS [Article 18]
1	<p>US Model</p> <p>Where an individual who is a member or beneficiary of, or participant in, a pension fund established in one of the Contracting States exercises an employment or self-employment in the other Contracting State:</p> <p>a) contributions paid by or on behalf of that individual to the pension fund during the period that he exercises an employment or self-employment in the other Contracting State shall be deductible (or excludible) in computing the individual's taxable income in that other Contracting State; and</p> <p>b) any benefits accrued under the pension fund, or contributions made to the pension fund by or on behalf of the individual's employer, during that period shall not be treated as part of the employee's taxable income and any such contributions shall be allowed as a deduction in computing the taxable income of the individual's employer in that other Contracting State.</p> <p>The relief available under this paragraph shall not exceed the relief that would be allowed by the other Contracting State to residents of that Contracting State for contributions to, or benefits accrued under, a pension plan established in that Contracting State.</p>		
2	<p>The provisions of paragraph 1 of this Article shall not apply unless:</p> <p>a) contributions by or on behalf of the individual, or by or on behalf of the individual's employer, to the pension fund (or to another similar pension fund established in the same Contracting State for which the first-mentioned pension fund was substituted) were made before the individual began to exercise an employment or self-employment in the other Contracting State; and</p> <p>b) the competent authority of the other Contracting State has agreed that the pension fund generally corresponds to a pension fund established in that other Contracting State.</p>		
3	<p>a) Where a citizen of the United States who is a resident of ----- exercises an employment in ----- the income from which is taxable in -----, the contribution is borne by an employer who is a resident of ----- or by a permanent establishment situated in -----, and the individual is a member or beneficiary of, or participant in, a pension plan established in -----,</p> <p>i) contributions paid by or on behalf of that individual to the pension fund during the period that the individual exercises the employment in -----, and that are</p>		

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	<p>attributable to the employment, shall be deductible (or excludible) in computing the individual's taxable income in the United States; and</p> <p>ii) any benefits accrued under the pension fund, or contributions made to the pension fund by or on behalf of the individual's employer, during that period, and that are attributable to the employment, shall not be included in computing the employee's taxable income in the United States.</p> <p>b) The relief available under this paragraph shall not exceed the lesser of:</p> <p>i) the relief that would be allowed by the United States to its residents for contributions to, or benefits accrued under, a generally corresponding pension plan established in the United States; and</p> <p>ii) the amount of contributions or benefits that qualify for tax relief in -----.</p> <p>c) For purposes of determining an individual's eligibility to participate in and receive tax benefits with respect to a pension fund established in the United States, contributions made to, or benefits accrued under, a pension fund established in ----- shall be treated as contributions or benefits under a generally corresponding pension fund established in the United States to the extent relief is available to the individual under this paragraph.</p> <p>d) This paragraph shall not apply unless the competent authority of the United States has agreed that the pension fund generally corresponds to a pension fund established in the United States.</p>		
<p>Comments US Model: Article 18 of the US Model relating to Pension Funds is not present in the OECD and UN Models.</p>			
19	GOVERNMENT SERVICE	GOVERNMENT SERVICE	GOVERNMENT SERVICE
1	(a) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or	(a) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or	<i>Notwithstanding the provisions of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen) and 20 (Students and Trainees):</i> (a) Salaries, wages and other remuneration, <i>other</i>

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	<p>authority shall be taxable only in that State.</p> <p>(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:</p> <p>(i) is a national of that State; or</p> <p>(ii) did not become a resident of that State solely for the purpose of rendering the services.</p>	<p>authority shall be taxable only in that State.</p> <p>(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:</p> <p>(i) is a national of that State; or</p> <p>(ii) Did not become a resident of that State solely for the purpose of rendering the services.</p>	<p>than a pension, paid to an individual in respect of services rendered to a Contracting State or a political subdivision or local authority thereof shall, subject to the provisions of subparagraph b) of this paragraph, be taxable only in that Contracting State;</p> <p>(b) such remuneration, however, shall be taxable only in the other Contracting State if the services are rendered in that Contracting State and the individual is a resident of that Contracting State who:</p> <p>i) is a national of that Contracting State; or</p> <p>ii) did not become a resident of that Contracting State solely for the purpose of rendering the services.</p>
<p>Comments</p> <p>UN & OECD Models: Article 19(1)(a) of the OECD Model is identical to Article 19(1)(a) of the UN model.</p> <p>Article 19(1)(b) of the OECD Model is identical to Article 19(1)(b) of the UN Model.</p> <p>US & OECD Models: Article 19(1)(a) and 19(1)(b) of the US Model is similar to Article 19(1)(a) and 19(1)(b) of the OECD Model, with minor difference in language, which is highlighted in US Model column.</p>			

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2	<p>(a) Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.</p> <p>(b) However, such pensions and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.</p>	<p>2.(a) Notwithstanding the provisions of paragraph 1, pension and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.</p> <p>(b) However, such pension and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.</p>	<p><i>Notwithstanding the provisions of paragraph 1 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support):</i></p> <p>a) <i>any</i> pension and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that Contracting State or subdivision or authority <i>(other than a payment to which paragraph 3 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) applies)</i> shall, subject to the provisions of subparagraph b) of this paragraph, be taxable only in that Contracting State;</p> <p>(b) such pension and other similar remuneration, however, shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that Contracting State.</p>

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<p>Comments UN & OECD Models: Article 19(2)(a) of the OECD Model is identical to Article 19(2)(a) of the UN Model. Article 19(2)(b) of the OECD Model is identical to Article 19(2)(b) of the UN Model. US & OECD Models: Article 19(2) of the US Model is similar to Article 19(2) of the OECD Model, with minor difference in language, which is highlighted in US Model column</p>			
3	The provisions of Articles 15, 16, 17, and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.	The provisions of articles 15, 16, 17 and 18 shall apply to salaries, wages pensions and other similar remuneration in respect of service rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.	The provisions of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen) and 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) shall apply to salaries, wages and other similar remuneration, and to pensions and other similar remuneration , in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.
<p>Comments UN & OECD Models: Article 19(3) of the OECD Model is identical to Article 19(3) of the UN Model. US & OECD Models: Article 19(3) of the US Model is similar to Article 19(3) of the OECD Model, with minor difference in language, which is highlighted in US Model column.</p>			
20	STUDENTS	STUDENTS	STUDENTS & TRAINEES
1	Payments which a student or business	1 Payments which a student or business	1. Payments, other than remuneration for

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	<p>apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.</p>	<p>trainee or apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.</p>	<p>personal services, received by a student or business trainee who is, or was immediately before visiting a Contracting State, a resident of the other Contracting State, and who is present in the first-mentioned Contracting State for the purpose of his full-time education or for his full-time training, shall not be taxed in that Contracting State, provided that such payments arise outside that Contracting State, and are for the purpose of his maintenance, education or training. The exemption from tax provided by this paragraph shall apply to a business trainee only for a period of time not exceeding twelve months from the date the business trainee first arrives in the first-mentioned Contracting State for the purpose of training.</p>
			<p>2. A student or business trainee within the meaning of paragraph 1 of this Article shall be exempt from tax by the</p>

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			<p><i>Contracting State in which the individual is temporarily present with respect to income from personal services in an aggregate amount equal to \$10,000 or its equivalent in [] for the taxable year of payment. The competent authorities of the Contracting States may adjust the amount provided in this paragraph to the extent necessary to take into account changes in the personal exemption, standard deduction or filing thresholds in the domestic laws of either Contracting State.</i></p>
			<p><i>3. For purposes of this Article, a business trainee is an individual:</i></p> <ul style="list-style-type: none"> <i>a) who is temporarily in a Contracting State for the purpose of securing training required to qualify the individual to practice a profession or professional specialty;</i> <i>or</i> <i>b) who is temporarily in a Contracting State as an employee of, or under</i>

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			<i>contract with, a resident of the other Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the other Contracting State (or a connected person with respect to such resident of the other Contracting State).</i>
<p>Comments</p> <p>UN & OECD Models: Article 20 of the OECD Model is similar to Article 20 of the UN Model except with the minor difference i.e. addition of words ‘trainee or’ in UN model.</p> <p>US & OECD Models: Article 20(1) of the US Model is similar to Article 20 of the OECD Model, with certain differences relating to compensation for personal services and presence for full time education or training, which are highlighted in US Model column.</p> <p>Article 20(2) of the US Model providing for threshold limit of exemption from tax for student or business trainees and Article 20(3) of the US Model defining a business trainee, are absent in OECD and UN Models.</p>			
21	OTHER INCOME	OTHER INCOME	OTHER INCOME
1	Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.	Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention shall be taxable only in that State.	Items of income beneficially owned by a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
<p>Comments</p> <p>UN & OECD Models: Article 21(1) of the OECD Model is identical to Article 21(1) of the UN Model.</p> <p>US & OECD Models: Article 21(1) of the US Model is similar to Article 21(1) of the OECD</p>			

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Model, with difference relating to beneficial ownership of the income, which is highlighted in US Model column.			
			<p>2. Notwithstanding paragraph 1 of this Article:</p> <p>a) a guarantee fee arising in a Contracting State and characterized as other income by that Contracting State and beneficially owned by a resident of the other Contracting State that is a connected person with respect to the payor of the guarantee fee may be taxed in the first mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to the guarantee fee in its Contracting State of residence; and</p> <p>b) in the case of the United States, a guarantee fee characterized as other income paid by an expatriated entity and beneficially owned by a company resident in _____ that is a connected person with respect to such expatriated entity may be taxed in accordance with the law of the United States for a</p>

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			<p>period of ten years beginning on the date on which the acquisition of the domestic entity is completed. For purposes of applying this paragraph:</p> <p>i) no effect shall be given to any amendment to section 7874 of the Internal Revenue Code after the date of signature of this Convention; and</p> <p>ii) no entity shall be treated as an expatriated entity that:</p> <p>A) is a connected person with respect to the domestic entity immediately after the date on which the acquisition of the domestic entity is completed; and</p> <p>B) prior to that date, was never a connected person with respect to the domestic entity.</p> <p>However, an entity described in the preceding sentence shall become an expatriated entity if, subsequent to the date on which the acquisition of the domestic entity is completed, the entity joins in filing a U.S. consolidated return with</p>

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			either the domestic entity or another entity that was a connected person with respect to the domestic entity immediately prior to the date on which the acquisition of the domestic entity was completed.
2	The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment . In such case the provisions of Article 7 shall apply.	The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein , and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed	3. The provisions of paragraph 1 and 2 shall not apply to income, other than income from real property (immovable property) as defined in paragraph 2 of Article 6 (Income from Real Property (Immovable Property)), if the beneficial owner of the income , being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply.

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		base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.	
		3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.	
<p>Comments</p> <p>UN & OECD Models: Article 21(2) of the OECD Model has eliminated reference to independent personal services and fixed base. This is consistent with the deletion of Article 14 in the OECD Model.</p> <p>US & OECD Models: Article 21(3) of the US Model is similar to Article 21(2) of the OECD Model, with differences relating to beneficial ownership of the income, which are highlighted in US Model column.</p> <p>Article 21(3) of the UN Model is absent in the OECD and US Models.</p>			
22	CAPITAL	CAPITAL	Non Existent
1	Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting	Capital represented by immovable property referred to in article 6, owned by a resident of a Contracting State and situated in the other Contracting	

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	State, may be taxed in that other State.	State, may be taxed in that other State.	
<p>Comments UN & OECD Models: Article 22(1) of the OECD Model is identical to Article 22(1) of the UN Model. The US Model does not contain an Article on taxation of Capital.</p>			
2	Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State.	Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State <i>or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services,</i> may be taxed in that other State.	
<p>Comments UN & OECD Models: It is identical to Article 22(2) of the UN Model, except that the OECD Model, consequent to the deletion of Article 14 therein, does not mention the words “or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services”.</p>			
3	Capital of an enterprise of a	Capital of an enterprise of a Contracting State	

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	Contracting State that operates ships or aircraft in international traffic represented by such ships or aircraft, and by movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.	that operates ships or aircraft in international traffic represented by such ships or aircraft, and by movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.	
<p>Comments UN & OECD Models: Article 22(3) of the OECD Model is identically worded as Article 22(3) of the UN Model.</p>			
4	All other elements of capital of a resident of a Contracting State shall be taxable only in that State.	[All other elements of capital of a resident of a Contracting State shall be taxable only in that State]. (The question of the taxation of all other elements of capital of a resident of a Contracting State is left to bilateral negotiations. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves	

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		taxation to the State in which the capital is located).	
<p>Comments UN & OECD Models: Article 22(4) of the OECD Model is identically worded as Article 22(4) of the UN Model.</p>			
	LIMITATION ON BENEFITS [NON-EXISTENT]	LIMITATION ON BENEFITS [NON-EXISTENT]	LIMITATION ON BENEFITS [Article. 22]
1	<p>US Model Except as otherwise provided in this Article and in paragraph 6 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest) and paragraph 3 of Article 12 (Royalties), a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a “qualified person” as defined in paragraph 2 of this Article at the time when the benefit would be accorded.</p>		
2	<p>A resident of a Contracting State shall be a qualified person at a time when a benefit otherwise would be accorded by this Convention if, at that time, with respect to clause (i) of subparagraph (f) of this paragraph, on at least half of the days of any twelve-month period that includes the date when the benefit otherwise would be accorded, the resident is:</p> <ul style="list-style-type: none"> a) an individual; b) a Contracting State, or a political subdivision or local authority thereof or any agency or instrumentality of any such Contracting State, political subdivision or local authority; c) a company, if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either: <ul style="list-style-type: none"> i) its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or ii) the company’s primary place of management and control is in the Contracting State of which it is a resident; d) a company, if: <ul style="list-style-type: none"> i) at least 50 percent of the aggregate vote and value of the shares (and at least 50 percent of the aggregate vote and value of any disproportionate class 		

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	<p>of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subparagraph (c) of this paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner; and</p> <p>ii) with respect to benefits under this Convention other than under Article 10 (Dividends), less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph; (B) to persons that are connected persons with respect to the company described in this subparagraph and that benefit from a special tax regime with respect to the deductible payment; or (C) with respect to a payment of interest, to persons that are connected persons with respect to the company described in this subparagraph and that benefit from notional deductions described in subparagraph (e) of paragraph 2 of Article 11 (Interest);</p> <p>e) a person described in paragraph 2 of Article 4 (Resident) of this Convention, provided that:</p> <p>i) in the case of a person described in sub-clause (A) of clause (ii) of subparagraph (k) of paragraph 1 of Article 3 (General Definitions), more than 50 percent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; and</p> <p>ii) in the case of a person described in sub-clause (B) of clause (ii) of subparagraph (k) of paragraph 1 of Article 3 (General Definitions), the earnings of such person benefit exclusively, or almost exclusively, pension funds that satisfy the requirements of clause (i) of this subparagraph; or</p> <p>f) a person other than an individual, if:</p> <p>i) persons that are residents of that Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate vote and value (and at least 50 percent of the aggregate vote and value of any disproportionate class of shares) of the shares</p>		

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	<p>or other beneficial interests of such person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner; and</p> <p>ii) less than 50 percent of the person's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph; (B) to persons that are connected persons with respect to the person described in this subparagraph and that benefit from a special tax regime with respect to the deductible payment; or (C) with respect to a payment of interest, to persons that are connected persons with respect to the person described in this subparagraph and that benefit from notional deductions described in subparagraph (e) of paragraph 2 of Article 11 (Interest).</p>		
3	<p>a) A resident of a Contracting State shall be entitled to benefits under this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a trade or business in the first-mentioned Contracting State, and the income derived from the other Contracting State emanates from, or is incidental to, that trade or business. For purposes of this Article, the term "active conduct of a trade or business" shall not include the following activities or any combination thereof:</p> <ul style="list-style-type: none"> i) operating as a holding company; ii) providing overall supervision or administration of a group of companies; iii) providing group financing (including cash pooling); or iv) making or managing investments, unless these activities are carried on by a bank, insurance company or registered securities dealer in the ordinary course of its business as such. <p>b) If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from a connected person, the conditions described in subparagraph (a) of this paragraph shall be considered to be satisfied with respect to such item only if the trade or business activity conducted by the resident in the first-mentioned Contracting State to which the item is related is substantial in relation to the</p>		

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	<p>same or complementary trade or business activity carried on by the resident or such connected person in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.</p> <p>c) For purposes of applying this paragraph, activities conducted by persons connected to a resident of a Contracting State shall be deemed to be conducted by such resident.</p>		
4	<p>A company that is a resident of a Contracting State shall be entitled to a benefit under this Convention, regardless of whether the resident is a qualified person if, at the time when the benefit would be accorded, and on at least half of the days of a twelve-month period commencing or ending on the date when the benefit otherwise would be accorded:</p> <p>a) at least 95 percent of the aggregate vote and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner; and</p> <p>b) less than 50 percent of the company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions): (i) to persons that are not equivalent beneficiaries; (ii) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation; (iii) to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from a special tax regime with respect to the deductible payment, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of a special tax regime analogous to the definition in subparagraph (l) of paragraph 1 of Article 3 (General Definitions), the principles of the definition provided in this Convention shall apply, but without regard to the requirement in clause (v) of that definition; or (iv) with respect to a payment of interest, to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that</p>		

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	benefit from notional deductions of the type described in subparagraph (e) of paragraph 2 of Article 11 (Interest).		
5.	<p>A company that is a resident of a Contracting State that functions as a headquarters company for a multinational corporate group consisting of such company and its direct and indirect subsidiaries shall be entitled to benefits under this Convention with respect to dividends and interest paid by members of its multinational corporate group. A company shall be considered a headquarters company for this purpose only if:</p> <p>a) such company's primary place of management and control is in the Contracting State of which it is a resident;</p> <p>b) the multinational corporate group consists of companies resident in, and engaged in the active conduct of a trade or business in, at least four countries, and the trades or businesses carried on in each of the four countries (or four groupings of countries) generate at least 10 percent of the gross income of the group;</p> <p>c) the trades or businesses of the multinational corporate group that are carried on in any one state other than the Contracting State of residence of such company generate less than 50 percent of the gross income of the group;</p> <p>d) no more than 25 percent of such company's gross income is derived from the other Contracting State;</p> <p>e) such company is subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3 of this Article; and</p> <p>f) less than 50 percent of such company's gross income, and less than 50 percent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions): (i) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article; (ii) to persons that are connected persons with respect to such company and that benefit from a special tax regime with respect to the deductible payment; or (iii) with respect to a payment of interest, to persons that are connected persons with respect to such company and that benefit from notional deductions described in subparagraph (e) of paragraph 2 of Article 11 (Interest).</p>		

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	If the requirements of subparagraph (b), (c) or (d) of this paragraph are not fulfilled for the relevant taxable year, they shall be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four taxable years.		
6.	If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3, 4 or 5 of this Article, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority a substantial nontax nexus to its Contracting State of residence and that neither its establishment, acquisition or maintenance, nor the conduct of its operations had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which the request has been made shall consult with the competent authority of the other Contracting State before either granting or denying a request made under this paragraph by a resident of that other Contracting State.		
7	<p>For the purposes of this Article:</p> <p>a) the term “recognized stock exchange” means: i) any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; ii) the _____ Stock Exchange; and iii) any other stock exchange agreed upon by the competent authorities of the Contracting States;</p> <p>b) the term “principal class of shares” means the ordinary or common shares of the company, provided that such class of shares represents the majority of the aggregate vote and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate vote and value of the company;</p> <p>c) the term “disproportionate class of shares” means any class of shares of a company, or in the case of a trust, any class of beneficial interests in such trust, resident in one of the Contracting States that entitles the shareholder or interest holder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State;</p> <p>d) a company’s “primary place of management and control” is in the Contracting State of which it is a resident only if:</p>		

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	<p>i) the executive officers and senior management employees of the company exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries in that Contracting State, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State, than in any other state; and</p> <p>ii) such executive officers and senior management employees exercise responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, than the officers or employees of any other company;</p> <p>e) the term “equivalent beneficiary” means:</p> <p>i) a resident of any state, provided that:</p> <p>A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that state and the Contracting State /from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article, provided that, if such convention does not contain a comprehensive limitation on benefits article, the resident would be entitled to the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article if such resident were a resident of one of the Contracting States under Article 4 (Resident) of this Convention. Notwithstanding the preceding sentence, an individual who is (1) liable to tax in his or her state of residence with respect to foreign source income or gains only on a remittance or similar basis, or (2) whose tax is determined in that Contracting State on a fixed-fee, “forfait” or similar basis, shall not be considered an equivalent beneficiary; and</p> <p>B) 1) with respect to income referred to in Article 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention, if the resident had received such income directly, the resident would be entitled under such convention, a provision of domestic law or any other international agreement, to a rate of tax with respect to such income for which benefits are being sought under this Convention that is less than or equal to the rate applicable under this Convention. Regarding a company seeking benefits under paragraph 4 of this Article with respect to dividends, for purposes of this sub-clause:</p>		

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	<p>I) if the resident is an individual, and the company is engaged in the active conduct of a trade or business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the trade or business that generated the earnings from which the dividend is paid, such individual shall be treated as if he or she were a company. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be conducted by such company. Whether a trade or business activity is substantial shall be determined based on all the facts and circumstances; and 49</p> <p>II) if the resident is a company (including an individual treated as a company), to determine whether the resident is entitled to a rate of tax that is less than or equal to the rate applicable under this Convention, the resident's indirect ownership of the shares of the company paying the dividends shall be treated as direct ownership; or</p> <p>2) with respect to an item of income, profit or gain referred to in Article 7 (Business Profits), 13 (Gains) or 21 (Other Income) of this Convention, the resident is entitled to benefits under such convention that are at least as favorable as the benefits that are being sought under this Convention; and</p> <p>C) notwithstanding that a resident may satisfy the requirements of subclauses (A) and (B) of this clause, where the item of income, profit or gain has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of the company seeking benefits, if the item of income, profit or gain would not be treated as the income, profit or gain of the resident under a provision analogous to paragraph 6 of Article 1 (General Scope) of this Convention had the resident, and not the company seeking benefits under paragraph 4 of this Article, itself owned the entity through which the income, profit or gain was derived by the company, such resident shall not be considered an equivalent beneficiary with respect to the item of income; and</p> <p>ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under paragraph 5 of this Article, provided that, in the case of a resident described in paragraph 5 of this Article, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate</p>		

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	<p>applicable under this Convention to the company seeking benefits under paragraph 4 of this Article; or</p> <p>iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph (a), (b), (c) or (e) of paragraph 2 of this Article, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 of this Article does not exceed 25 percent of the total vote and value 50 of the shares (and any disproportionate class of shares) of the company.</p> <p>f) the term "qualifying intermediate owner" means an intermediate owner that is either:</p> <p>i) a resident of a state that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation that includes provisions addressing special tax regimes and notional deductions analogous to subparagraph (l) of paragraph 1 of Article 3 (General Definitions) and subparagraph (e) of paragraph 2 of Article 11 (Interest), respectively; or</p> <p>ii) a resident of the same Contracting State as the company applying the test under subparagraph (d) or (f) of paragraph 2 or paragraph 4 of this Article to determine whether it is eligible for benefits under the Convention;</p> <p>g) the term "tested group" means the resident of a Contracting State that is applying the test under subparagraph (d) or (f) of paragraph 2 of this Article or paragraph 4 or 5 of this Article to determine whether it is eligible for benefits under the Convention (the "tested resident"), and any company that:</p> <p>i) participates as a member with the tested resident in a tax consolidation, fiscal unity or similar regime that requires members of the group to share profits or losses; or</p> <p>ii) shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the taxable year; and</p> <p>h) the term "gross income" means gross receipts as determined in the person's Contracting State of residence for the taxable year that includes the time when the benefit would be accorded, except that where a person is engaged in a business that includes the manufacture, production or sale of goods, "gross income" means such gross receipts reduced by the cost of goods sold, and where a person is engaged in a business of providing non-financial services, "gross income" means such gross receipts reduced by the direct costs of generating such receipts, provided that:</p>		

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	<p>i) except when relevant for determining benefits under Article 10 (Dividends) of this Convention, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person's Contracting State of residence, whether through deductions or otherwise; and 51</p> <p>ii) except with respect to the portion of any dividend that is taxable, a tested group's gross income shall not take into account transactions between companies within the tested group.</p>		
<p>Comments US Model: Article 22 of the US Model relating to Limitation of Benefits, is absent in both OECD and UN Models.</p>			
23A	EXEMPTION METHOD	METHODS FOR THE ELIEMINATION OF DOUBLE TAXATION [Article 23]	RELIEF FROM DOUBLE TAXATION [Article 23]
1	Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall,	Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State, in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall, subject to the provisions of	

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	subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.	paragraphs 2 and 3, exempt such income or capital from tax.	
<p>Comments UN & OECD Models: Articles 23A(1)/23B(1) of the OECD model are identical to Article 23A(1)/ 23B(1) of the UN Model. Article similar to Article 23A of the OECD Model is absent in the US Model.</p>			
2	Where a resident of a Contracting State derives items of income which may be taxed in the other Contracting State in accordance with the provisions of Articles 10 and 11 (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State), the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as	2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10, 11, 12, 12A and 12B may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income which may be taxed in that other State.	

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	computed before the deduction is given, which is attributable to such items of income derived from that other State.		
<p>Comments UN & OECD Models: Article 23A(2) of the OECD Model differs from Article 23A(2) in the UN Model, to the extent that OECD Model does not refer to Article 12, 12A and 12B(the newly inserted article in UN model convention 2021).</p>			
3	Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.	3. Where in accordance with any provision of this Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.	
<p>Comments UN & OECD Models: Article 23A(3) of the OECD Model is similarly worded as Article 23A(3) of the UN Model except for very minor difference in language.</p>			
4	The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of	The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State	

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	a Contracting State where the other Contracting State applies the provisions of the Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.	where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11, 12 or 12A, or the provisions of Article 12B, to such income; in the case where the other Contracting State does not exempt the income, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2.	
<p>Comments UN & OECD Models: Article 23A(4) of the OECD Model differs from Article 23A(4) in the UN Model, as highlighted in UN model</p>			
23B	CREDIT METHOD	CREDIT METHOD	CREDIT METHOD
1	Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that	Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other	1. In the case of -----, double taxation will be relieved as follows:

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	<p>other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall allow:</p> <p>a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;</p> <p>b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.</p> <p>Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.</p>	<p>State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall allow:</p> <p>a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;</p> <p>b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.</p> <p>Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.</p>	

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<p>Comments UN & OECD Models: Article 23B(1) of the UN/OECD Models incorporates the principles in Article 23A(2) of the US Model.</p>			
2	<p>Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.</p>	<p>Where, in accordance with any provision of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.</p>	<p><i>2. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens:</i></p> <p><i>a) the income tax paid or accrued to ----- by or on behalf of such resident or citizen; and</i></p> <p><i>b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is a resident of ----- and from which the United States company receives dividends, the income tax paid or accrued to --- ---- by or on behalf of the payer with respect to the profits out of which the dividends are paid.</i></p> <p><i>For the purposes of this</i></p>

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			<i>paragraph, the taxes referred to in paragraphs 3 a) and 4 of Article 2 (Taxes Covered) shall be considered income taxes.</i>
			<i>3 For the purposes of applying paragraph 2 of this Article, an item of gross income, as determined under the law of the United States, derived by a resident of the United States that, under this Convention, may be taxed in _____ shall be deemed to be income from sources in _____.</i>
			<i>4. Where a United States citizen is a resident of _____: a) with respect to items of income, profit or gain that under the provisions of this Convention are exempt from United States tax or that are subject to a reduced rate of United States tax when derived by a resident of _____ who is not a United States citizen, _____ shall allow</i>

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			<p><i>as a credit against _____ tax only the tax paid, if any, that the United States may impose under the provisions of this Convention other than taxes that may be imposed solely by reason of citizenship under paragraph 4 of Article 1 (General Scope);</i></p> <p><i>b) for purposes of applying paragraph 2 to compute United States tax on those items of income, profit or gain referred to in subparagraph (a) of this paragraph, the United States shall allow as a credit against United States tax the income tax paid to _____ after the credit referred to in subparagraph (a) of this paragraph; the credit so allowed shall not reduce the portion of the United States tax that is creditable against the _____ tax in accordance with subparagraph (a) of this</i></p>

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			<p><i>paragraph; and c) for the exclusive purpose of relieving double taxation in the United States under subparagraph (b) of this paragraph, items of income, profit or gain referred to in subparagraph (a) of this paragraph shall be deemed to arise in ____ to the extent necessary to avoid double taxation of such income under subparagraph (b) of this paragraph.</i></p>
<p>Comments</p> <p>UN & OECD Models: Articles 23A(3) and 23B(2) of the OECD Model are identically worded as Article 23A(3) and 23B(2) of the UN Model.</p> <p>US & OECD Models: Article 23(2) of the US Model is different from the Article 23A(3) and 23B(2) of the OECD Model, in many respects.</p>			
24	NON-DISCRIMINATION	NON-DISCRIMINATION	NON-DISCRIMINATION
1	Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and	1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected	Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which

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	<p>connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.</p>	<p>requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.</p>	<p>nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall also apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States taxation, United States nationals who are subject to tax on a worldwide basis are not in the same circumstances as nationals of ----- who are not residents of the United States.</p>
<p>Comments UN & OECD Models: Article 24(1) of the OECD Model is identical to Article 24(1) of the UN Model. US & OECD Models: Article 24(1) of the US Model is similar to Article 24(1) of the OECD Model, with differences in language, which are highlighted in US model column.</p>			
2	<p>Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more</p>	<p>2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more</p>	

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	burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.	burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.	
<p>Comments</p> <p>UN & OECD Models: Article 24(2) of the OECD Model is identical to Article 24(2) of the UN Model.</p> <p>US & OECD Models: Article 24(2) of the OECD Model dealing with stateless persons, is absent in US Model.</p>			
3	The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal	3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances,	<p>2. The taxation on a permanent establishment <i>that an</i> enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.</p> <p>3. <i>The provisions of paragraphs 1 and 2</i> shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation</p>

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	allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.	reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.	purposes on account of civil status or family responsibilities that it grants to its own residents.
<p>Comments</p> <p>UN & OECD Models: Article 24(3) of the OECD Model is identical to Article 24(3) of the UN Model.</p> <p>US & OECD Models: Article 24(3) of the OECD Model, is bifurcated into Article 24(2) and 24(3) of the US model, with minor differences in language, which are highlighted in US Model column.</p>			
4	Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12 , apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.	4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, paragraph 6 of Article 12, paragraph 7 of Article 12A or paragraph 11 of Article 12B apply, interest, royalties, fees for technical services, payments underlying income from automated digital services , and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable	4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 7 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of the first-mentioned resident , be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a

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	Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.	profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.	resident of the other Contracting State shall, for the purpose of determining the taxable capital of the <i>first-mentioned resident</i> , be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
<p>Comments</p> <p>UN & OECD Models: Article 24(4) of the OECD Model is similar to Article 24(4) of the UN Model except for the differences highlighted in the UN model.</p> <p>US & OECD Models: Article 24(4) of the US Model is similar to Article 24(4) of the OECD model, with minor differences in language, which are highlighted in US Model column, having the same meaning and implications.</p>			
5	Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting	5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting	5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be

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	State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.	State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.	subjected in the first-mentioned State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
<p>Comments UN & OECD Models: Article 24(5) of the OECD Model is identical to Article 24(5) of the UN Model. US & OECD Models: Article 24(5) of the US Model is similar to Article 24(5) of the OECD model, with minor difference in language, which is highlighted in US Model column, having the same meaning and implications.</p>			
			6. Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax as described in paragraph 10 of Article 10 (Dividends) or paragraph 7 of Article 11 (Interest).
<p>Comments UN & OECD Models: Article 24(6) of the US Model is absent in the OECD and UN Models.</p>			
6	The provisions of this Article shall, notwithstanding the	6. The provisions of this article shall, notwithstanding the	7. The provisions of this Article shall, notwithstanding the

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	provisions of Article 2, apply to taxes of every kind and description.	provisions of article 2, apply to taxes of every kind and description.	provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description.
<p>Comments</p> <p>UN & OECD Models: Article 24(6) of the OECD Model is identical to Article 24(6) of the UN Model.</p> <p>US & OECD Models: Article 24(7) of the US Model is similar to Article 24(6) of the OECD model.</p>			
25	MUTUAL AGREEMENT PROECDURE	MUTUAL AGREEMENT PROECDURE	MUTUAL AGREEMENT PROECDURE
		(alternative A)	
1	Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of <i>either</i> Contracting State. The case must be presented within three years from the first notification of the action resulting in	Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national.	Where a person considers that the actions of one or both of the Contracting States result or will result for such person in taxation not in accordance with the provisions of this Convention, it may, irrespective of the remedies provided by the domestic law of those States, and the time limits prescribed in such laws for presenting claims for refund , present its case to the competent authority of one or both Contracting State.

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	taxation not in accordance with the provisions of the Convention.	The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.	
<p>Comments</p> <p>UN & OECD Models: Article 25(1) of the OECD Model is identical to Article 25(1) of the UN Model with a minor difference highlighted in UN Model Column</p> <p>US & OECD Models: Article 25(1) of the US Model is similar to Article 25(1) of the OECD model, with differences in language, which are highlighted in US Model column.</p>			
2	The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the	The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the	The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation that is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States. Assessment and collection procedures

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	Contracting States.	Contracting States.	<i>shall be suspended during the period that any mutual agreement proceeding is pending.</i>
<p>Comments</p> <p>UN & OECD Models: Article 25(2) of the OECD Model is identical to Article 25(2) of the UN Model.</p> <p>US & OECD Models: Article 25(2) of the US Model is similar to Article 25(2) of the OECD model, with differences in language, which are highlighted in US Model column. In addition, article 25(2) of the US Model provides for suspension of assessment and collection procedures during the pendency of the MAP proceedings.</p>			
3	The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.	3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.	<i>The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They also may consult together for the elimination of double taxation in cases not provided for in the Convention. In particular the competent authorities of the Contracting States may agree:</i> <i>a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated</i>

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			<p><i>in the other Contracting State;</i></p> <p><i>b) to the same allocation of income, deductions, credits, or allowances between persons;</i></p> <p><i>c) to the settlement of conflicting application of the Convention, including conflicts regarding:</i></p> <ul style="list-style-type: none"> <i>i) the characterization of particular items of income;</i> <i>ii) the characterization of persons;</i> <i>iii) the application of source rules with respect to particular items of income;</i> <i>iv) the meaning of any term used in the Convention;</i> <i>v) the timing of particular items of income;</i> <p><i>d) to advance pricing arrangements; and</i></p> <p><i>e) to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the</i></p>

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			<i>Convention.</i>
			4. The competent authorities also may agree to increases in any specific dollar amounts referred to in the Convention to reflect economic or monetary developments.
<p>Comments</p> <p>UN & OECD Models: Article 25(3) of the OECD Model is identical to Article 25(3) of the UN Model.</p> <p>US & OECD Models: Like Article 25(3) of the OECD Model, Article 25(3) of the US Model also provides that the competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. However, Article 25(3) along with Article 25(4) of the US Model also specifically elaborates on the areas on which Competent Authorities may agree.</p>			
4	The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives , for the purpose of reaching an agreement in the sense of the preceding paragraphs.	4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate	5. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

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		<i>bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article.</i>	
			<p>6. Where a person has presented a case to the competent authority of one or both of the Contracting States either:</p> <p>a) pursuant to paragraph 1 of this Article on the basis that the actions of one or both of the Contracting States resulted or will result for that person in taxation not in accordance with the provisions of this Convention; or</p> <p>b) on a taxpayer-specific case regarding a matter described in paragraph 3 of this Article;</p> <p>and the competent authorities are unable to reach agreement to resolve that case, and the conditions described in paragraph 7 of this Article are met, the case shall be resolved through arbitration conducted in the manner prescribed by paragraphs 7 through 9 of this Article and according</p>

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			to any rules or procedures agreed upon by the competent authorities of the Contracting States pursuant to paragraph 10 of this Article.
			<p>7. A case shall be submitted to arbitration on the earliest date on which all of the following conditions have been satisfied:</p> <ul style="list-style-type: none"> a) tax returns have been filed with at least one of the Contracting States with respect to the taxable years at issue in the case; b) at least two years have passed since the commencement date of such case, unless the competent authorities of the Contracting States have agreed to a different date and notified the presenter of the case of such agreement; c) the presenter of the case has submitted a written request to the competent authority to which the case was presented for a resolution of the case through arbitration; and d) all concerned persons and their authorized representatives or agents

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			<p>have submitted to the competent authorities of both Contracting States written agreements not to disclose to any other person any information received during the course of the arbitration proceeding from either Contracting State or the arbitration panel, other than the determination of the panel.</p> <p>A case shall not, however, be submitted to arbitration if a decision with respect to such case has already been rendered by a court or administrative tribunal of either Contracting State, or if the competent authorities of the Contracting States have agreed prior to the date on which the arbitration otherwise would be submitted that the particular case is not suitable for resolution through arbitration.</p>
			<p>8. For the purposes of this Article, the following definitions shall apply:</p> <p>a) the term “presenter” means the person that has presented a case to the competent authority of one</p>

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			<p>or both of the Contracting States either:</p> <ul style="list-style-type: none"> i) pursuant to paragraph 1 of this Article on the basis that the actions of one or both of the Contracting States result or will result for that person in taxation not in accordance with the provisions of this Convention; or ii) on a taxpayer-specific case regarding a matter described in paragraph 3 of this Article; <p>b) the term “concerned person” means the presenter and all other persons, if any, whose tax liability to either Contracting State may be directly affected by a mutual agreement to resolve a case submitted to arbitration pursuant to paragraph 7 of this Article; and</p> <p>c) the “commencement date” for a case means the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities.</p>

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			9. Rules are prescribed for the purpose of arbitrations.
<p>Comments</p> <p>UN & OECD Models: Article 25(4) of the UN Model consists of two sentences, the first of which reproduces the first sentence of the Article 25(4) of the OECD Model while the second sentence is not contained in the OECD Model.</p> <p>US & OECD Models: Article 25(5) of the US Model is similar to Article 25(4) of the OECD Model, with minor difference in language, which is highlighted in OECD Model Column.</p>			
5	<p>Where,</p> <p>a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and</p> <p>b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities,</p>		

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	<p>any unresolved issues arising from the case shall be submitted to arbitration if the person so requests in writing. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.</p>		

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Comments on UN Model - Article 25 - alternative A and alternative B			
<p>These alternatives were introduced in 2011 in the UN Model. Article 25A of the UN Model reproduces Article 25 of the OECD Model, with the addition of a second sentence in paragraph (4) relating to development of appropriate bilateral procedures, conditions, methods and techniques but excludes arbitration as provided in Article 25(5) of the OECD Model. Article 25B of the UN Model reproduces Article 25 of the OECD Model with the addition of the aforementioned second sentence in paragraph (4) and also includes arbitration as provided in Article 25(5) of the OECD Model albeit with certain differences. However, paragraphs 1 to 4 of the both the alternative versions of Article 25 of the UN Model are identical.</p>			
		(alternative B)	
		<p><i>1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a</i></p>	

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		<p><i>national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.</i></p>	
		<p><i>2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.</i></p>	

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		<p><i>3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.</i></p>	
		<p><i>4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through</i></p>	

Article/ Para No.	OECD Model Tax Convention on Income and on Capital 1992 [November 2017 Update]	UN Model Convention 2021	US Model Income Tax Convention 2016
		<p><i>consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.</i></p>	
		<p>5. Where, (a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and (b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within three years from the presentation of the case to the competent authority of the other Contracting State any unresolved issues</p>	

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		<p>arising from the case shall be submitted to arbitration if either competent authority so requests. The person who has presented the case shall be notified of the request. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. The arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or unless a person directly affected by the case</p>	

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		<p>does not accept the mutual agreement that implements the arbitration decision. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.</p>	
<p>Comments</p> <p>UN & OECD Models: Article 25(5) of the OECD Model differs from Article 25B(5) of the UN Model as follows:</p> <p>(a) Article 25B(5) of the UN Model provides that an arbitration may be initiated if the competent authorities are unable to reach an agreement on a case within three years from the presentation of that case. However, Article 25(5) of the OECD Model provides a time limit of two years.</p> <p>(b) Article 25B(5) of the UN Model provides that arbitration must be requested by the competent authority of one of the Contracting States. However, as per Article 25(5) of the OECD Model, arbitration must be requested by the person who initiated the case.</p> <p>(c) Article 25B(5) of the UN Model, unlike Article 25(5) of the OECD Model, allows the competent authorities to depart from the arbitration decision if they agree to do so within six months after the decision has been communicated to them.</p> <p>US & OECD Models: Article similar to Article 25(5) of the OECD Model is absent in the US Model.</p>			
26	EXCHANGE OF INFORMATION	EXCHANGE OF INFORMATION	EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE
1.	The competent authorities of the Contracting States	The competent authorities of the Contracting States	The competent authorities of the Contracting States shall exchange such

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	<p>shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.</p>	<p>shall exchange such information as is necessary for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws of the Contracting States concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. <i>In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes.</i> The exchange of information is not restricted by Articles 1 and 2.</p>	<p>information as is <i>foreseeably relevant for carrying</i> out the provisions of this Convention or the domestic laws of the Contracting States concerning taxes of every kind imposed by a Contracting State to the extent that the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes. The exchange of information is not restricted by paragraph 1 of Article 1 (General Scope) or Article 2 (Taxes Covered).</p>
<p>Comments UN & OECD Models: Article 26(1) of the OECD Model does not have the second last sentence in Article 26(1) of the UN Model which provides as follows: “In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes”.</p>			

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US & OECD Models: Article 26(1) of the US Model is similar to Article 26(1) of the OECD Model, with difference in language, highlighted in US Model column.			
2	Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing,	Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.	Any information received under this Article by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic law of that Contracting State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes referred to in paragraph 1 of this Article, or the oversight of such functions. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the preceding sentences of this paragraph, the competent authority of the Contracting State that

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	<p>information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.</p>		<p>receives information under the provisions of this Article may, with the written consent of the Contracting State that provided the information, also make available that information for other purposes allowed under the provisions of a mutual legal assistance treaty in force between the Contracting States that allows for the exchange of tax information.</p>
<p>Comments UN & OECD Models: The last sentence in Article 26(2) of the OECD Model has been added in 2012. It is absent in the UN Model. This sentence has been analysed in the OECD Commentary and Indian “Manual on Exchange of Information” released by CBDT in May 2015. US & OECD Models: Article 26(2) of the US Model is similar to Article 26(2) of the OECD Model, with minor different. However, the last sentence in Article 26(2) of the OECD Model which has been added in 2012, is absent in US Model.</p>			
3	<p>In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation: a) to carry out administrative measures at variance with the laws and administrative practice</p>	<p>In no case shall the provisions of paragraph 1 and 2 be construed so as to impose on a Contracting State the obligation: (a) To carry out administrative measures at variance with the laws and administrative practice</p>	<p>In no case shall the provisions of the paragraphs 1 and 2 of this Article be construed so as to impose on a Contracting State the obligation: a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;</p>

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	<p>of that or of the other Contracting State; b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).</p>	<p>of that or of the other Contracting State; (b) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; (c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).</p>	<p>b) to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; c) to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.</p>
<p>Comments UN & OECD Models: Article 26(3) of the OECD Model is identically worded as Article 26(3) of the UN Model. US & OECD Models: Article 26(3) of the US Model is similar to Article 26(3) of the OECD Model.</p>			
4	<p>If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested</p>	<p>If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested</p>	<p>If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other</p>

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	information, even though that other State may not need such information for its own tax purposes . The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.	information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.	State may not need such information for its own purposes . The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitation be construed to permit a Contracting State to decline to supply information because it has no domestic interest in such information.
<p>Comments</p> <p>UN & OECD Models: It is identical to Article 26(4) of the UN Model.</p> <p>US & OECD Models: Article 26(4) of the US Model is similar to Article 26(4) of the OECD Model, with minor difference in language, highlighted in US Model column, having almost the same meaning and implications.</p>			
5	In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an	5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an	5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to

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	agency or a fiduciary capacity or because it relates to ownership interests in a person.	agency or a fiduciary capacity or because it relates to ownership interests in a person.	ownership interests in a person.
<p>Comments US, UN & OECD Models: Article 26(5) was added in the OECD Model to reflect practices amongst many OECD member countries. It is identical to Article 26(5) of the UN Mode and 26(5) of US Model.</p>			
		<p><i>6. The competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made.</i></p>	<p><i>6. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings).</i></p>
<p>Comments UN & OECD Models: Article 26(6) of the UN Model is absent in the OECD Model. The position taken in the OECD Commentary is that the authority provided in Article 26(6) of the UN Model is implicit in Article 26 of the OECD Model. US & OECD Models: Article 26(6) of the US Model is mostly on similar lines as Article 26(6) of the OECD Model, with differences in language, highlighted in US Model column.</p>			
			<p><i>7. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such</i></p>

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			<p><i>amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled thereto. This paragraph shall not impose upon either of the Contracting States the obligation to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.</i></p>
			<p><i>8. The requested State shall allow representatives of the requesting State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.</i></p> <p><i>9. The competent authorities of the Contracting States may develop an agreement upon the mode of application of this Article, including agreement to ensure comparable levels of</i></p>

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			<i>assistance to each of the Contracting States, but in no case will the lack of such agreement relieve a Contracting State of its obligations under this Article.</i>
<p>Comments: US & OECD Models: Article 26(7) to 26(9) of the US Model are absent in OECD and UN Models.</p>			
27	ASSISTANCE IN THE COLLECTION OF TAXES	ASSISTANCE IN THE COLLECTION OF TAXES	NON EXISTENT
1	1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Articles 1 and 2. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.	1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Articles 1 and 2. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.	
<p>Comments <i>UN & OECD Models:</i> Article 27(1) of the UN model is identical to Article 27 (1) of the OECD Model. <i>US Model:</i> There is corresponding Article relating to Assistance in the collection of Taxes in US Model.</p> <p>A footnote in the OECD and Un Models mention: “<i>In some countries, national law, policy or administrative considerations may not allow or justify the type of assistance envisaged</i>”</p>			

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<p><i>under this Article or may require that this type of assistance be restricted, e.g. to countries that have similar tax systems or tax administrations or as to the taxes covered. For that reason, the Article should only be included in the Convention where each State concludes that, based on the factors described in paragraph 1 of the Commentary on the Article, they can agree to provide assistance in the collection of taxes levied by the other State."</i></p>			
2	<p>The term "revenue claim" as used in this Article means an amount owed in respect of taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation there under is not contrary to this Convention or any other instrument to which the Contracting States are parties, as well as interest, administrative penalties and costs of collection or conservancy related to such amount.</p>	<p>The term "revenue claim" as used in this Article means an amount owed in respect of taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation there under is not contrary to this Convention or any other instrument to which the Contracting States are parties, as well as interest, administrative penalties and costs of collection or conservancy related to such amount.</p>	
<p>Comments UN & OECD Models: Article 27(2) of the UN model is identical to Article 27(2) of the OECD Model.</p>			
3	<p>When a revenue claim of a Contracting State is enforceable under</p>	<p>When a revenue claim of a Contracting State is enforceable under</p>	

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	<p>the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State.</p>	<p>the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State.</p>	
<p>Comments UN & OECD Models: Article 27(3) of the UN model is identical to Article 27(3) of the OECD Model.</p>			
4	<p>When a revenue claim of a Contracting State is a claim in respect of which that State may, under its law, take</p>	<p>When a revenue claim of a Contracting State is a claim in respect of which that State may, under its law, take</p>	

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	<p>measures of conservancy with a view to ensure its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of taking measures of conservancy by the competent authority of the other Contracting State. That other State shall take measures of conservancy in respect of that revenue claim in accordance with the provisions of its laws as if the revenue claim were a revenue claim of that other State even if, at the time when such measures are applied, the revenue claim is not enforceable in the first mentioned State or is owed by a person who has a right to prevent its collection.</p>	<p>measures of conservancy with a view to ensure its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of taking measures of conservancy by the competent authority of the other Contracting State. That other State shall take measures of conservancy in respect of that revenue claim in accordance with the provisions of its laws as if the revenue claim were a revenue claim of that other State even if, at the time when such measures are applied, the revenue claim is not enforceable in the first mentioned State or is owed by a person who has a right to prevent its collection.</p>	
<p>Comments UN & OECD Models: Article 27(4) of the UN model is identical to Article 27(4) of the OECD Model.</p>			
5	Notwithstanding the provisions of	Notwithstanding the provisions of	

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	<p>paragraphs 3 and 4, a revenue claim accepted by a Contracting State for purposes of paragraph 3 or 4 shall not, in that State, be subject to the time limits or accorded any priority applicable to a revenue claim under the laws of that State by reason of its nature as such. In addition, a revenue claim accepted by a Contracting State for the purposes of paragraph 3 or 4 shall not, in that State, have any priority applicable to that revenue claim under the laws of the other Contracting State.</p>	<p>paragraphs 3 and 4, a revenue claim accepted by a Contracting State for purposes of paragraph 3 or 4 shall not, in that State, be subject to the time limits or accorded any priority applicable to a revenue claim under the laws of that State by reason of its nature as such. In addition, a revenue claim accepted by a Contracting State for the purposes of paragraph 3 or 4 shall not, in that State, have any priority applicable to that revenue claim under the laws of the other Contracting State.</p>	
<p>Comments UN & OECD Models: Article 27(5) of the UN model is identical to Article 27(5) of the OECD Model.</p>			
6	<p>Proceedings with respect to the existence, validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or</p>	<p>Proceedings with respect to the existence, validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or</p>	

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	administrative bodies of the other Contracting State.	administrative bodies of the other Contracting State.	
<p>Comments UN & OECD Models: Article 27(6) of the UN model is identical to Article 27(6) of the OECD Model.</p>			
7	<p>Where, at any time after a request has been made by a Contracting State under paragraph 3 or 4 and before the other Contracting State has collected and remitted the relevant revenue claim to the first-mentioned State, the relevant revenue claim ceases to be</p> <p>a) in the case of a request under paragraph 3, a revenue claim of the first-mentioned State that is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, or</p> <p>b) in the case of a</p>	<p>Where, at any time after a request has been made by a Contracting State under paragraph 3 or 4 and before the other Contracting State has collected and remitted the relevant revenue claim to the first-mentioned State, the relevant revenue claim ceases to be:</p> <p>(a) in the case of a request under paragraph 3, a revenue claim of the first-mentioned State that is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, or</p> <p>(b) in the case of a request under</p>	

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	request under paragraph 4, a revenue claim of the first-mentioned State in respect of which that State may, under its laws, take measures of conservancy with a view to ensure its collection the competent authority of the first-mentioned State shall promptly notify the competent authority of the other State of that fact and, at the option of the other State, the first mentioned State shall either suspend or withdraw its request.	paragraph 4, a revenue claim of the first-mentioned State in respect of which that State may, under its laws, take measures of conservancy with a view to ensure its collection, the competent authority of the first-mentioned State shall promptly notify the competent authority of the other State of that fact and, at the option of the other State, the first-mentioned State shall either suspend or withdraw its request.	
<p>Comments UN & OECD Models: Article 27(7) of the UN model is identical to Article 27(7) of the OECD Model.</p>			
8	In no case shall the provisions of this Article be construed so as to impose on a Contracting State the obligation: a) to carry out administrative measures at variance with the laws and	In no case shall the provisions of this Article be construed so as to impose on a Contracting State the obligation: (a) to carry out administrative measures at variance with the laws and	

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	<p>administrative practice of that or of the other Contracting State;</p> <p>b) to carry out measures which would be contrary to public policy (ordre public);</p> <p>c) to provide assistance if the other Contracting State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice;</p> <p>d) to provide assistance in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the other Contracting State.</p>	<p>administrative practice of that or of the other Contracting State;</p> <p>(b) to carry out measures which would be contrary to public policy (ordre public);</p> <p>(c) to provide assistance if the other Contracting State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice;</p> <p>(d) to provide assistance in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the other Contracting State.</p>	
<p>Comments</p> <p>UN & OECD Models: Article 27(8) of the UN model is identical to Article 27(8) of the OECD Model.</p>			

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28	MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS [Article 28]	MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS [Article 28]	MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS [Article 27]
	Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.	Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.	Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.
<p>Comments UN, US & OECD Models: Article 28 of the OECD Model relating to Members of Diplomatic Missions and Consular Posts, is identically worded as Article 28 of the UN Model and Article 27 of the US Model.</p>			
	NON-EXISTENT	NON-EXISTENT	SUBSEQUENT CHANGES IN LAW [Article 28]
			1. If at any time after the signing of this Convention, a Contracting State reduces the general statutory rate of company tax that applies with respect to substantially all of the income of resident companies with the result that such rate falls below the lesser of either (a) 15 percent or (b) 60 percent of the general statutory rate of

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			<p>company tax applicable in the other Contracting State, or the first-mentioned Contracting State provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties), the Contracting States shall consult with a view to amending this Convention to restore an appropriate allocation of taxing rights between the Contracting States. If such consultations do not progress, the other Contracting State may notify the first-mentioned Contracting State through diplomatic channels that it shall cease to apply the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income). In such case, the provisions of such Articles shall cease to have effect in both Contracting States with respect to payments to resident companies six months after the date that the other Contracting State issues a written public notification stating that it shall cease to</p>

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			apply the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income).
			<p>2. For the purposes of determining the general statutory rate of company tax:</p> <p>a) the allowance of generally available deductions based on a percentage of what otherwise would be taxable income, and other similar mechanisms to achieve a reduction in the overall rate of tax, shall be taken into account; and</p> <p>b) a tax that applies to a company only upon a distribution by such company, or that applies to shareholders, shall not be taken into account.</p>
29	ENTITLEMENT TO BENEFITS	ENTITLEMENT TO BENEFITS	ENTITLEMENT TO BENEFITS – NON EXISTENT
1.	Provision that, subject to paragraphs 3 to 5, restricts treaty benefits to a resident of a Contracting State who is a “qualified person” as defined in paragraph 2.	UN Model : Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25) unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.	

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UN & OECD Models: Article 29(1) of the OECD Model is similar to Article 29(1) of the UN Model except with differences in wordings.			
2.	<p>Definition of situations where a resident is a qualified person, which covers</p> <ul style="list-style-type: none"> - an individual; - a Contracting State, its political subdivisions and their agencies and instrumentalities; - certain publicly-traded companies and entities - certain affiliates of publicly-listed companies and entities; - certain non-profit organisations and recognised pension funds; - other entities that meet certain ownership and base erosion requirements; - certain collective investment vehicles. 	<p>A resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is:</p> <ul style="list-style-type: none"> (a) an individual; (b) that Contracting State, or a political subdivision or local authority thereof, or an agency or instrumentality of that State, political subdivision or local authority; (c) a company or other entity, if, throughout the taxable period that includes that time, the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either: (i) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or (ii) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident; (d) a company, if: (i) throughout the taxable period that includes that time, at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subparagraph c) of this paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought 	

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		<p>or is a qualifying intermediate owner; and (ii) with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e);</p> <p>(e) a person, other than an individual, that</p> <p>(i) is a [agreed description of the relevant non-profit organisations found in each Contracting State],</p> <p>(ii) is a recognised pension fund;</p> <p>(f) a person other than an individual, if:</p> <p>(i) at that time and on at least half the days of a twelve-month period that includes that time, persons .who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) own, directly or indirectly, shares representing at least 50 per cent of the aggregate vote and value (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) of the shares in the person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and</p> <p>(ii) less than 50 per cent of the person's gross</p>	

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		<p>income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions), to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph (a), (b), (c) or (e) of this paragraph; or</p> <p>(g) a collective investment vehicle to which paragraph 4 of Article 1 applies;</p>	
<p>UN & OECD Models: Article 29(2) of the OECD Model is different to Article 29(2) of the UN Model, the definition as per UN Model is more explanatory as compared to OECD Model.</p>			
<p>3.</p>	<p>Provision that provides treaty benefits to certain income derived by a person that is not a qualified person if the person is engaged in the active conduct of a business in its State of residence and the income emanates from, or is incidental to, that business.</p>	<p>(a) A resident of a Contracting State shall be entitled to benefits under this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first-mentioned State and the income derived from the other State emanates from, or is incidental to, that business. For purposes of this Article, the term "active conduct of a business" shall not include the following activities or any combination thereof:</p> <ul style="list-style-type: none"> (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing group financing (including cash pooling); or (iv) making or managing investments, unless 	

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		<p>these activities are carried on by a bank [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer in the ordinary course of its business as such.</p> <p><i>(b) If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other State from a connected person, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the first-mentioned State to which the item is related is substantial in relation to the same or complementary business activity carried on by the resident or such connected person in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.</i></p> <p><i>(c) For purposes of applying this paragraph, activities conducted by connected persons with respect to a resident of a Contracting State shall be deemed to be conducted by such resident.</i></p>	
<p>UN & OECD Models: Article 29(3)(b) and 29(3)(c) of the UN Model is absent from OECD Model.</p>			
4.	Provision that provides treaty benefits to a person that is not a qualified person if at least more than an agreed proportion of that entity is owned by	A rule providing so-called derivative benefits. The question of how the derivative benefits paragraph should be drafted in a convention that follows the detailed version is discussed in the Commentary	

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	certain persons entitled to equivalent benefits		
UN & OECD Models: Article 29(4) of the OECD Model is different from Article 29(4) of the UN Model in its entirety			
5.	Provision that provides treaty benefits to a person that qualifies as a “headquarters company”.	A company that is a resident of a Contracting State that functions as a headquarters company for a multinational corporate group consisting of such company and its direct and indirect subsidiaries shall be entitled to benefits under this Convention with respect to dividends and interest paid by members of its multinational corporate group, regardless of whether the resident is a qualified person. A company shall be considered a headquarters company for this purpose only if: (a) such company’s primary place of management and control is in the Contracting State of which it is a resident; (b) the multinational corporate group consists of companies resident of, and engaged in the active conduct of a business in, at least four States, and the businesses carried on in each of the four States (or four groupings of States) generate at least 10 per cent of the gross income of the group; (c) the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company generate less than 50 per cent of the gross income of the group; (d) no more than 25 per cent of such company’s gross income is derived from the other Contracting State; (e) such company is subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3 of this Article; and (f) less than 50 per cent of such company’s gross income, and less than 50 per cent of the tested group’s gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes	

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		<p>of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of paragraph 2. If the requirements of subparagraph b), c) or d) of this paragraph are not fulfilled for the relevant taxable period, they shall be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four taxable periods.</p>	
<p>UN & OECD Models: Article 29(5) of the OECD Model is different from Article 29(5) of the UN Model, UN Model provides an elaborative definition of headquarters of the company.</p>			
6.	<p>Provision that allows the competent authority of a Contracting State to grant certain treaty benefits to a person where benefits would otherwise be denied under paragraph 1.</p>	<p>If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3, 4 or 5, the competent authority of the Contracting State in which benefits are denied under the previous provisions of this Article may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income or capital, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which a request has been made, under this paragraph, by a resident of the other State, shall consult with the competent authority of that other State before either granting or</p>	

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		denying the request.	
7	Definitions applicable for the purposes of paragraphs 1 to 7	<p>For the purposes of this and the previous paragraphs of this Article:</p> <p>(a) the term “recognised stock exchange” means:</p> <p>(i) list of stock exchanges agreed to at the time of signature; and</p> <p>(ii) any other stock exchange agreed upon by the competent authorities of the Contracting States;</p> <p>(b) with respect to entities that are not companies, the term “shares” means interests that are comparable to shares;</p> <p>(c) the term “principal class of shares” means the ordinary or common shares of the company or entity, provided that such class of shares represents the majority of the aggregate vote and value of the company or entity. If no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company or entity, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate vote and value;</p> <p>(d) two persons shall be “connected persons” if one owns, directly or indirectly, at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares) or another person owns, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.</p> <p>(e) the term “equivalent beneficiary” means: (i) a resident of any State, provided that: (A) the resident is entitled to all the benefits of a comprehensive</p>	

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		<p>convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, such convention shall be applied as if the provisions of subparagraphs a), b), c) and e) of paragraph 2 (including the definitions relevant to the application of the tests in such subparagraphs) were contained in such convention; and</p> <p>(B) (1) with respect to income referred to in Article 10, 11, 12 12A or 12B if the resident had received such income directly, the resident would be entitled under such Convention, a provision of domestic law or any international agreement, to a rate of tax with respect to such income for which benefits are being sought under this Convention that is less than or equal to the rate applicable under this Convention. Regarding a company seeking, under paragraph 4, the benefits of Article 10 with respect to dividends, for purposes of this subclause:</p> <p>(I) if the resident is an individual, and the company is engaged in the active conduct of a business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the business that generated the earnings from which the dividend is paid, such individual shall be treated as if he or she were a company. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be</p>	

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		<p>conducted by such company. Whether a business activity is substantial shall be determined based on all the facts and circumstances; and</p> <p>(II) if the resident is a company (including an individual treated as a company), to determine whether the resident is entitled to a rate of tax that is less than or equal to the rate applicable under this Convention, the resident's indirect holding of the capital of the company paying the dividends shall be treated as a direct holding; or</p> <p>(2) with respect to an item of income referred to in Article 7, 13 or 21 of this Convention, the resident is entitled to benefits under such Convention that are at least as favourable as the benefits that are being sought under this Convention; and</p> <p>(C) notwithstanding that a resident may satisfy the requirements of clauses A) and B) of this subdivision, where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking benefits, if the item of income would not be treated as the income of the resident under a provision analogous to paragraph 2 of Article 1 had the resident, and not the company seeking benefits under paragraph 4 of this Article, itself owned the entity through which the income was derived by the company, such resident shall not be considered an equivalent beneficiary with respect to the item of income;</p> <p>(ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under</p>	

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		<p>paragraph 5, provided that, in the case of a resident described in paragraph 5, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate applicable under this Convention to the company seeking benefits under paragraph 4; or</p> <p>(iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 does not exceed 25 per cent of the total vote and value of the shares (and any disproportionate class of shares) of the company;</p> <p>(f) the term "disproportionate class of shares" means any class of shares of a company or entity resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company;</p> <p>(g) a company's or entity's "primary place of management and control" is in the Contracting State of which it is a resident only if:</p> <p>(i) the executive officers and senior management employees of the company or entity exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, in that</p>	

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		<p>Contracting State than in any other State; and</p> <p>(ii) such executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-today activities necessary for preparing and making those decisions, than the officers or employees of any other company or entity;</p> <p>(h) the term “qualifying intermediate owner” means an intermediate owner that is either:</p> <p>(i) a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation; or</p> <p>(ii) a resident of the same Contracting State as the company applying the test under subparagraph d) or f) of paragraph 2 or paragraph 4 to determine whether it is eligible for benefits under the Convention;</p> <p>(i) the term “tested group” means the resident of a Contracting State that is applying the test under subparagraph d) or f) of paragraph 2 or under paragraph 4 or 5 to determine whether it is eligible for benefits under the Convention (the “tested resident”), and any company or permanent establishment that:</p> <p>(i) participates as a member with the tested resident in a tax consolidation, fiscal unity or similar regime that requires members of the group to share profits or losses; or</p> <p>(ii) shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the relevant taxable period; [and]</p> <p>(j) the term “gross income” means gross receipts as determined in the person’s Contracting State of</p>	

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		<p>residence for the taxable period that includes the time when the benefit would be accorded, except that where a person is engaged in a business that includes the manufacture, production or sale of goods, “gross income” means such gross receipts reduced by the cost of goods sold, and where a person is engaged in a business of providing non-financial services, “gross income” means such gross receipts reduced by the direct costs of generating such receipts, provided that: (i) except when relevant for determining benefits under Article 10 of this Convention, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person’s Contracting State of residence, whether through deductions or otherwise; and (ii) except with respect to the portion of any dividend that is taxable, a tested group’s gross income shall not take into account transactions between companies within the tested group;</p>	
<p>UN & OECD Models: Article 29(7) of the OECD Model is different from Article 29(7) of the UN Model, UN Model provides definitions of various terms.</p>			
8	<p>a) Where (i) an enterprise of a Contracting State derives income from the other Contracting State and the first - mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and (ii) the profits attributable to that permanent</p>	<p>(a) Where (i) an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and (ii) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State, the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain</p>	

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	<p>establishment are exempt from tax in the first - mentioned State, the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first - mentioned State on that item of income if that permanent establishment were situated in the first - mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention. b) The preceding provisions of this paragraph shall not apply if the income derived from the other</p>	<p>taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention. (b) The preceding provisions of this paragraph shall not apply if the income derived from the other State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively). (c) If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.</p>	

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	<p>State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).</p> <p>c) If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such</p>		

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	<p>competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.</p>		
<p>UN & OECD Models: Article 29(8) of the OECD Model is similar to from Article 29(8) of the UN Model with minor difference in language as highlighted.</p>			
9	<p>Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the</p>	<p>Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.</p>	

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	principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.		
UN & OECD Models: Article 29(8) of the OECD Model is identical to from Article 29(8) of the UN Mode.			
30	TERRITORIAL EXTENSION	NON-EXISTENT	NON-EXISTENT
1	<p>OECD Model</p> <p>This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or], to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.</p>		
2	<p>Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 32 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.</p>		

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<p>Comments UN & OECD Models: Article 29 of the OECD Model relating to Territorial Extension is absent in UN and US Models.</p>			
31	ENTRY INTO FORCE [Article 31]	ENTRY INTO FORCE [Article 30]	ENTRY INTO FORCE [Article 29]
1	This Convention shall be ratified and the instruments of ratification shall be exchanged at ____ as soon as possible.	1. This Convention shall be ratified and the instruments of ratification shall be exchanged at ____ as soon as possible.	1. This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State. <i>The Contracting States shall notify each other in writing, through diplomatic channels when their respective applicable procedures have been satisfied.</i>
2	The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect: a) (in State A): b) (in State B):	2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect: (a) (In State A): (b) (In State B):	This Convention shall enter into force <i>on the date of the later of the notifications referred to in paragraph 1 of this Article.</i> The provisions of this Convention shall have effect: a) <i>in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which this Convention enters into force;</i> b) <i>in respect of other taxes, for taxable years beginning on or after the</i>

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			first day of January next following the date on which this Convention enters into force.
			<p>3. Notwithstanding paragraph 2 of this Article:</p> <p>a) the provisions of paragraphs 6 through 10 of Article 25 (Mutual Agreement Procedure) of this Convention shall have effect with respect to:</p> <p>i) Cases that are under consideration by the competent authorities as of the date on which this Convention enters into force. For such cases, the commencement date shall be the date on which this Convention enters into force; and</p> <p>ii) cases that come under consideration after the date on which this Convention enters into force; and</p> <p>b) the provisions of Article 26 (Exchange of Information and Administrative Assistance) shall have effect from the date of entry into force of this Convention, without</p>

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			regard to the taxable year to which the matter relates..
<p>Comments</p> <p>UN & OECD Models: Article 30 of the UN Model and Article 31 of the OECD Model are identically worded.</p> <p>US Model: Article 28(1) and 28(2) of the US Model relating to ‘Entry into Force’ are similar to Article 30(1) and 30(2) of the OECD Model, with differences, which are highlighted in US Model Column. Article 28(3) of the US Model is absent in OECD and UN Models.</p>			
32	TERMINATION [Article 32]	TERMINATION [Article 31]	TERMINATION [Article 30]
	<p>This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year _____. In such event, the Convention shall cease to have effect:</p> <p>a) (in State A):</p> <p>b) (in State B):</p>	<p>This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year _____. In such event, the Convention shall cease to have effect:</p> <p>(a) (In State A):</p> <p>(b) (In State B):</p>	<p>This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention by giving notice of termination to the other Contracting State through diplomatic channels. In such event, the Convention shall cease to have effect:</p> <p>a) in respect of taxes withheld at source, for amounts paid or credited after the expiration of the 6 month period beginning on the date on which notice of termination was given; and</p> <p>b) in respect of other taxes, for taxable</p>

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			<i>periods beginning on or after the expiration of the 6 month period beginning on the date on which notice of termination was given.</i>
<p>Comments UN & OECD Models: Article 30 of the UN Model and Article 31 of the OECD Model are identically worded. US Model: Article 29 of the US Model relating to ‘Termination’ is similar to Article 31 of the OECD Model, with differences, which are highlighted in US Model Column.</p>			

Unit II	Articles in the Model Conventions keeping in view the UN convention
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1. Article 1 – Persons Covered

Article 1 of the United Nations (UN) model Convention titled “Persons Covered” is phrased as “This Convention shall apply to persons who are residents of one or both of the Contracting States.”

This Article is specifically meant to describe the persons qualifying for Double taxation Avoidance Agreement (“DTAA”/ “Tax Treaty”). Since Tax Treaties are always agreed upon and signed between two countries (“Contracting States”), the benefits of the same shall be available only to person resident of one or both of the Contracting States. Originally Tax Treaties were directed, expressly or implicitly only at citizens of the Contracting States.

Every jurisdiction, in its domestic tax law, prescribes the mechanism to determine residential status of a person. If a person is considered to be resident of both the Contracting States, relief should be sought from Article 4 of the DTAA. Article 4 provides for tie-breaker norm for resolving tax residency issue and to determine a single State of residence. On the other hand, a person who is not a resident of any or both Contracting States will not be eligible to claim Tax Treaty benefit although the person may be liable to tax in those States on basis of source rule.

However, there are certain Articles that would even apply to persons who may not be residents of either of the Contracting States, such as:

- Article 24(1) (Non-discrimination) which is applicable to “nationals” of the Contracting States; and
- Article 26(1) (Exchange of Information) which permits information to be exchanged in respect of residents of a third state.

Given that only residents of a contracting state are covered under Article 1, questions arise with respect to the availability of a treaty to Permanent Establishments (“PE”), Partnerships and transparent entities, and government bodies.

PE’s do not enjoy a separate or distinct legal identity from their head office and hence are not considered to qualify as persons. Hence PE’s on a standalone basis may not be eligible to claim Tax Treaty benefits. However, there can be a situation where an owner of PE will also be a resident of the contracting state i.e. the source country and accordingly the PE can enjoy treaty benefits. Typically this can also give rise to a triangular cases. For example, where a PE in State A which belongs to an enterprise resident in State B receives income from a third country, say State C, then while determining the taxability of income sourced from State C, State C treaty with State B may need to be applied instead of State C with State A. The term “Resident” stated in Article 1 has been defined in Article 4 of Tax Treaties which inter alia means a person who, under the laws of that contracting state, is liable to tax therein by reason of his domicile, residence, place of management, or any other criterion of a similar nature. In respect of

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Partnership/fiscally transparent entities: difficulties arise when one of the two contracting states treat them as independent taxable entities, whilst the other one attributes their profits and assets directly to the individual partners/beneficiaries. Availability of Tax Treaty benefits in India to partnerships and other transparent entities has been a vexed issue with jurisprudence being mostly fact based. Accordingly, the treaty entitlement of partnership/fiscally transparent entities is dependent on characteristics of the partnership/fiscally transparent entity and the domestic laws of the concerned state.

In respect of Government bodies, political sub-divisions or local authority, it has been the general understanding of most countries that the Government of a State, political sub-division and local authorities thereof are resident of that State for the purpose of the Convention, though they are not liable to tax in that state. Before 1995, the Model conventions did not explicitly state this, however in 1995, to avoid controversies and conflicting positions being adopted, the definition of term 'resident' was amended to include the Government of a State, political sub-division and local authorities thereof.

Article 1 of the Organisation for Economic Co-operation and Development ("OECD") Model Convention ("MC") and the United Nations ("UN") MC is identical to the extent of Paragraph 1 stating that the Convention will apply to one or both of the Contracting States. The update to the OECD MC in 2017 includes Paragraph 2 and 3 which are as follows:

"2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

3. This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28."

Paragraph 2 addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes.

Paragraph 3 confirms the general principle that the Convention does not restrict a Contracting State's right to tax its own residents except where this is intended and lists the provisions with respect to which that principle is not applicable.

The United States ("US") MC **also** contains additional provisions with respect to the "general scope" of the said treaty.

Paragraph 1 of Article 1 of US MC reads as follows:

"This Convention shall apply only to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention."

Paragraph 2 of Article 1 of US MC reads as follows:

“This convention shall not restrict in any manner any benefit now or hereafter accorded:

- a). by the laws of either contracting state; or*
- b). by any other agreement to which the Contracting State are parties.”*

Paragraph 2 implies that no provision in the Tax Treaty may restrict any exclusion, exemption, deduction, credit or other benefit allowed by the tax laws of the Contracting States, or by any other agreement between the Contracting States¹.

For example, where a deduction is granted under the U.S. Internal Revenue Code (“the Code”) in computing the U.S taxable income of a resident of the other Contracting State, then such deduction is to be allowed to that person in computing taxable income under the Tax Treaty. Paragraph 2 also implies that the Tax Treaty may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law. Therefore, unless the right to tax does not exist under the internal law then such a right to tax cannot be exercised even if it is provided for by the Tax Treaty.

Subparagraph (b) of paragraph 2, means that no provisions contained in the Tax Treaty can be used to deny any benefit granted by any other agreement between the United States and the other Contracting State.

Paragraph 3 of Article 1 of US MC reads as follows:

“a). Notwithstanding the provisions of subparagraph b) of paragraph 2 of this Article:

- i) for purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that any question arising as to the interpretation or application of this Convention and, in particular, whether a taxation measure is within the scope of this Convention, shall be determined exclusively in accordance with the provisions of Article 25 (Mutual Agreement Procedure) of this Convention; and*
- ii) the provisions of Article XVII of the General Agreement on Trade in Services shall not apply to a taxation measure unless the competent authorities agree that the measure is not within the scope of Article 24 (Non-Discrimination) of this Convention.*

b). For the purposes of this paragraph, a “measure” is a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.”

Subparagraph (b) of Paragraph 2 provides that no provisions contained in the Tax Treaty can be used to deny any benefit granted by any other agreement between the United States and the other Contracting State and as a notwithstanding clause, Paragraph 3 is an exception to the provisions of subparagraph b) of Paragraph 2. Paragraph 3 specifically relates to non-

¹US model Technical Explanation (2006)

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discrimination obligations of the Contracting States under the General Agreement on Trade in Services (“the GATS”)².

Subparagraph (a) of paragraph 3 suggests that any question arising as to the interpretation of the Tax Treaty, including in particular whether a measure is within the scope of the Tax Treaty shall be deliberated only by the competent authorities of the Contracting States (i.e., by invoking Article 25 – Mutual Agreement Procedure, which facilitates resolving difficulties arising out of the application of the Tax Treaty), and the procedures under the Tax Treaty exclusively shall apply to the dispute. Hence, the national treatment obligations of the GATS will apply to a measure only when the competent authorities (by applying Article 25) have determined that a taxation measure is not within the scope of the Tax Treaty.

The term "measure" for these purposes is defined broadly in subparagraph (b) of paragraph 3. It would include, for example, a law, regulation, rule, procedure, decision, administrative action or guidance, or any other form of measure³.

Paragraph 4 of Article 1 of US MC reads as follows:

“Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status, be taxed in accordance with the laws of that Contracting State.”

Paragraph 4 contains the traditional saving clause found in all U.S. Tax Treaties⁴, wherein subject to the provisions of paragraph 5 and notwithstanding any provisions of the Tax Treaty to the contrary, the Contracting States have the right to tax their residents and citizens in accordance with their internal laws. For example, if a resident of the other Contracting State earns income from professional services rendered by him in the United States and where the same is not attributable to a permanent establishment in the United States, then on application of Article 7 (Business Profits) the United States will be precluded from taxing such income. If, however, the resident of the other Contracting State is also a citizen of the United States, paragraph 4 then permits the United States to tax the above-mentioned income under the Code by including it in the worldwide income of the citizen. Further, to avoid the issue of double taxation of a particular income, recourse can be drawn to the special foreign tax credit rules (subparagraph 5(a) of Article 1) applicable to the U.S. taxation of certain U.S. income of its citizens resident in the other Contracting State (see paragraph 4 of Article 23 - Relief from Double Taxation)⁵.

Hence, paragraph 4 provides that irrespective of the residential status of a person, a Contracting State would have the right to tax its citizens or even in certain cases, former citizens who have

²US model Technical Explanation (2006)

³ US model Technical Explanation (2006)

⁴ US model Technical Explanation (2006)

⁵ US model Technical Explanation (2006)

given up their citizenship.

Paragraph 5 of Article 1 of US MC reads as follows:

“The provisions of paragraph 4 shall not affect:

- a) *the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), paragraphs 1 b), 2, and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support), paragraphs 1 and 4 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and*
- b) *the benefits conferred by a Contracting State under paragraph 2 of Article 18 (Pension Funds), Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.”*

Paragraph 5 states certain exceptions to the saving clause (i.e. Paragraph 4). While the intention of provisions of subparagraph (a) of paragraph 5 is to provide benefits to citizens and residents (even if the internal laws of the Contracting States do not confer such benefits), subparagraph (b) of paragraph 5 is intended to grant the benefits referred to therein to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State.

Paragraph 6 of Article 1 of US MC reads as follows:

“An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.”

The distinct issues stemming from the fiscally transparent entities such as partnerships and certain estates and trusts are dealt with in paragraph 6. The cause of such issues is the difference in opinions among the different countries as to when an entity is fiscally transparent, thereby increasing the risk of both double taxation and double non-taxation.

Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies (“LLCs”) that are treated as partnerships or as disregarded entities for U.S. tax purposes⁶.

The implication of paragraph 6 can be explained with the following example. If a company that is a resident of the other Contracting State pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the U.S. only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law)

⁶ US model Technical Explanation (2006)

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as deriving the interest for U.S. tax purposes⁷.

In the case of a partnership, the persons whom the U.S. tax laws would treat as deriving the interest income through the partnership would be the persons who are, under U.S. tax laws, treated as partners of the entity. The paragraph also infers that if a person is considered as a partner by the United States but is not a U.S. resident for U.S. tax purposes, then he may not claim a benefit for the interest paid to the entity under the Tax Treaty, because he is not a resident of the United States for purposes of claiming this treaty benefit⁸.

Paragraph 6 is however not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 permits a Contracting State to tax an entity that is treated as a resident of that State under its tax law. For example, the members of a U.S. LLC are residents of the other Contracting State and they elect to be taxed as a corporation for U.S. tax purposes, then the United States will tax that LLC on its worldwide income on a net basis, irrespective of the other Contracting State viewing the LLC as fiscally transparent or not⁹.

Analysis of India-US DTAA

On specifically analysing the Tax Treaty entered into between India and US it can be observed that Paragraph 3 and 6 contained in Article 1 of the US MC pertaining to non-discrimination obligations of the Contracting States under the GATS and treatment of issues pertaining to fiscally transparent entities, respectively, have been excluded from the India-US DTAA.

Further, paragraph 4 of the US MC corresponds to paragraph 3 of the India-US DTAA. While the US MC allows each Contracting State to tax its former citizens and former long-term residents for a period of ten years following the loss of such status, in accordance with its internal laws, the India-US DTAA specifically provides the right to tax its former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

Improper use of convention

The OECD commentary on Article 1 provides that the principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion. Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws. Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned. Such a State is then unlikely to agree to provisions of bilateral double taxation conventions that would have the effect of allowing abusive transactions that would otherwise be prevented by the provisions and rules of this kind contained in its domestic law. Having considered the provisions of Article 1 as provided in the OECD/ UN/ US Tax Treaties, if we were to take a broader view, there arise other issues which are denying the benefits conferred by the treaties in the following circumstances:

⁷ US model Technical Explanation (2006)

⁸ US model Technical Explanation (2006)

⁹ US model Technical Explanation (2006)

1. Conduit Company cases – A conduit company is basically a company which is set up in connection with a tax avoidance scheme.
2. Anti-avoidance rules in domestic law – The treaty benefits cannot be availed if the domestic laws/ jurisprudential doctrines contain anti-avoidance rules.
3. Anti-avoidance rules in treaty – Treaty benefits could be denied when there are specific anti-avoidance provisions in the treaty i.e., the Limitation of Benefit (LOB) Article
4. Transactions are contrary to object and purpose – It basically deals with the issue of “treaty shopping”

1.1 Judicial Precedence

There are various jurisprudences in the Indian as well as the International context that have dealt with the above mentioned issues:

1.1.1 India

- The Vodafone case – The case concerns a tax dispute between the Vodafone group and the Indian Income Tax (IT) authorities over the acquisition by Vodafone International Holdings BV (VIH) (part of the Vodafone group and a company resident for tax purposes in the Netherlands) of the entire share capital of CGP Investments (Holdings) Ltd (a company incorporated in Hong Kong but resident for tax purposes in the Cayman Islands) from Hutchison Telecommunications International Ltd (HTIL).CGP, through various intermediate companies/contractual arrangements, controlled 67% of Hutchison Essar Limited (HEL), an Indian company. The acquisition resulted in Vodafone acquiring control over Hutch-Essar, a joint venture between the Hutchison group and the Essar group, which had obtained telecom licences to provide cellular telephone in different circles in India in November 1994. Because the sale was supposed to have been made overseas, no taxes were paid in India.

The IT authorities in India however, contended that the primary aim of this transaction was to acquire 67% controlling interest in Hutchison Essar Limited, a company resident in India. They therefore sought to tax capital gains under Section 9(1)(i) of the Indian Income Tax Act 1961 arising from the sale of the shares. Therefore, Vodafone, the buyer of the shares, had an obligation to withhold and pay the tax in India, before making the payment to Hutchison. The tax demand was contested by Vodafone, stating that neither Vodafone nor Hutch was liable to pay the tax as both the companies were located outside India and the deal was finalised outside India.

The case went up to the Supreme Court¹⁰ and, based on two key but independent arguments, the apex court concluded that there was no merit in the High Court's verdict which held that the transaction was one of transfer of capital assets situated in India, and accordingly, the tax authorities had jurisdiction over the matter. The first line of reasoning

¹⁰Vodafone International Holdings BV v UOI (2012) 341ITR1 (SC)

was that the transaction between Vodafone and Hutch was a share transfer (sale) rather than a transfer of capital assets and that the ownership of the capital assets remained vested in the Indian company. The judgment took recourse to the legal distinction between a company and its shareholders and thus the judgment does not make a distinction between shareholding that constituted a controlling interest and that which was a pure investment. Consequently, it becomes completely immaterial in this specific case that the share(s) actually transferred were not of the company located in India but of offshore companies that ultimately controlled the shares that constituted the controlling interest in the Indian company. Even if the shares were of a company located in India, in the court's view it would not have constituted a transfer of capital assets. Once it is accepted that the shareholders of a company have a legal identity distinct from the company, no matter what the proportion of shares they hold, it follows that the two companies would have distinct identities even if one held a controlling share in the other. The Supreme Court judgment makes a point to emphasise that even a subsidiary has an identity that is distinct from its parent holding company.

The second aspect of the Supreme Court judgment is that it argues for a "look at" test in which tax authorities consider the entire Hutchison structure as it existed, "holistically", at its face value, and not adopt a "dissecting approach". In other words, authorities should not ask whether the transaction is a tax avoidance method, but apply the "look at" test to ascertain its legal nature. The Supreme Court was not in favour of the High Court's "look through" test because, it claimed, this was inconsistent with the need for certainty and consistency of tax policies that are crucial for taxpayers' confidence (especially foreign investors). The judgment argues that such a going behind the "corporate veil" or looking through would be legitimate only in cases where it can be established that there is a deliberate intention of evading taxes. In the Supreme Court's view no such inference can be made in this case if the steps that led to the creation of the complex holding structure of Vodafone and the eventual Vodafone-Hutch transaction were seen in the proper context. According to the court the structuring of the transfer of control from Hutch to Vodafone was not done with the specific intention of avoiding taxes. Hence the corporate veil need not be pierced and the fact that there was a transfer of control from Hutch to Vodafone must be ignored. And thus the tax authorities should concern themselves only with the corporate structure or "form" of a merger deal, and not the "substance" of what assets are changing hands.

- In the case of *Arabian Express Line Ltd of United Kingdom v UOI*¹¹ the High Court held that in the case of availability of TRC, certificate of incorporation and a certificate of payment of UK taxes, the revenue cannot ignore the same and probe into the genuineness of the UK company.
- In the case of *DIT v. Besix kier Dabhol SA*¹², the High Court has affirmed the finding of the Tribunal wherein the Tribunal applying the judgement of the Supreme Court in *UOI v*

¹¹212 ITR 31 (Guj) (1995)

¹²210 Taxman 151 (Bom) (MAG.) (2012)

Azadi Bachao Andolan, held that when there are no anti-abuse provisions in the treaty, it was not open for the revenue to apply the anti-abuse provisions based on the judge made law in India.

- Finance Act, 2013 introduced GAAR provisions in the Act which provide that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising therefrom may be determined. Section 90(2A) provides that notwithstanding anything contained in sub-section (2), the GAAR provisions shall apply to the assessee even if such provisions are not beneficial to him. In other words, GAAR provisions shall override the tax treaty provisions. The Central Board of Direct Taxes (CBDT) Circular 7/2017, dated 27 January 2017, on GAAR clarification provides that adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules. If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR [Q. 2].
- LOB Article has been introduced in various Indian tax treaties like India-Mauritius DTAA, India-Singapore DTAA, India-Israel DTAA, etc.

LOB Article under India-Israel DTAA provides that tax treaty benefit will not be available to a resident of a contracting state or with respect to any transaction undertaken by such resident, if the main purpose or one of the main purposes of the creation or existence of such resident or of the transaction undertaken by it, was to obtain benefits of this tax treaty that would not otherwise be available. LOB Article **permits application of domestic General Anti-Avoidance Rules (GAAR) dealing with prevention of tax evasion or tax avoidance.**

1.1.2 Germany

The Federal Tax Court¹³ held that, without there being any other economic reason, the German Revenue cannot disregard the arrangement where a multinational group has arranged the holding of its subsidiaries in any manner whatsoever for the purpose of minimising tax liability.

1.1.3 Finland

The Supreme Administrative Court of Finland¹⁴ has held that if the domestic tax laws contain provisions which are directed at preventing international tax evasion, the Tax Treaties in such a situation do not prevent countries from applying such provisions of their domestic law.

1.1.4 Switzerland

The Federal Tax Appeals Commission of Switzerland¹⁵ has held as follows:

- Persons who are not residents of a Contracting State are not entitled to benefit from the

¹³ IBFD case no 26/73

¹⁴ IBFD case no 20.03.02/596; KHO: 2002:26

¹⁵ IBFD case no VPB 65.86

advantages of the Tax Treaty by interposing “shadow” companies.

- Switzerland may adopt anti-abuse measures in a unilateral fashion when a Tax Treaty is used to benefit nationals of third countries to ensure that there is no abuse of the Tax Treaty.
- Where a structure is created for example by interposing shadow companies that lack economic justification and is unwarranted, the treaty benefits can be denied.

Subsequently, the Swiss Supreme Court¹⁶ accepted that a prohibition on treaty abuse is a general legal principle of civilised nations and that a “look through” clause should be assumed to be, even if not explicitly, included in a treaty in a situation where the relevant entity does not engage in any genuine or active business activities.

1.1.5 USA

The Seventh Circuit Court¹⁷ in the case of Northern Indian Public Service Company recognized the transaction under question wherein a US based company set up a wholly owned subsidiary in the Netherlands for the purpose of obtaining funds for its operations and expansion through the issue of notes from the Eurobond market. The Court recognised the subsidiary in Netherlands and the transactions of procuring finance from the Eurobond market on the basis of its valid business purpose (including the non-tax purpose of obtaining cheaper financing), its profit making, its control over its investments, and it’s transacting with third parties.

1.1.6 Canada

The Court in the case of MIL (Investments) S.A.¹⁸ held that the provisions of GAAR could not be applied to deny the exemption claimed by the applicant under Canada-Luxembourg DTAA on the capital gains accrued on the sale of shares on the basis of the following observations:

- The applicant is a resident of Luxembourg and, as such, the treaty was applicable to it. Thus, although there was a tax benefit, there was no avoidance transaction.
- The sale of the Canadian Company shares to Inco, on its own, was arranged primarily for bona fide purpose other than to obtain a tax benefit on account of following:
 - It was a sale by all shareholders which was a result of a bidding war between Inco and other bidder.
 - The management information circular involving Inco and Canadian company provided that 75% of the shares voted at a shareholder’s meeting for the purpose of approving Inco’s offer were required.
 - Opinions were obtained that Inco’s offer was fair to the Canadian Company’s shareholders.

¹⁶ IBFD case no 2A.239/2005

¹⁷ Northern Indiana Public Service Company v. Commissioner of Internal Revenue, 105 T.C. 341 (1995)

¹⁸ MIL (Investments) S.A. vs. The Queen (2006)

There was a practical likelihood that the sale would not take place and that the management of the Canadian company and the appellant would have developed it on their own, but for the ultimately death of a metallurgist who worked for the Canadian Company (and was viewed as integral to the success of the company).

1.2 BEPS

The Base Erosion and Profit Shifting (BEPS) Action Plan 6 - Preventing the Granting of Treaty Benefits in Inappropriate Circumstances deals with (i) developing model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances (i.e. treaty abuse and treaty shopping cases); (ii) clarifying that tax treaties are not intended to be used to generate “double non-taxation”; and (iii) identify tax policy considerations for jurisdictions to consider before entering into treaties.

The Action Plan 6 recommends following three approaches to address treaty shopping arrangements:

- Clarification in treaty title and preamble to the effect that the Contracting States intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance;
- Inclusion of a specific anti-abuse rule based on LOB provisions (in line with such clauses in US tax treaties);
- Addition to tax treaties of a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the principal purposes test or ‘PPT’ rule).

In BEPS chapter of this module, the Action Plan 6 has been explained in detail.

Conclusion

Article 1 seeks to provide guidance on the persons who will be covered within the ambit of the Tax Treaties. This article assumes great significance while interpreting eligibility for benefits under Tax Treaties since it lays down the threshold for applicability of treaty benefits.

2. Article 2 –Taxes Covered

2.1 Background

Article 2 articulates the nomenclature of the term ‘taxes’ and its coverage as per the tax laws of the Contracting states. An expansive rather than a restrictive interpretation is justified¹⁹ to avoid the necessity to negotiate a new Treaty every time the domestic tax law is amended and to widen the field of application of the Tax Treaty to the political subdivisions or local authorities of the contracting states.

¹⁹ Kinsella v Revenue Commissioner (2007) IEHC 250 (Irish High Court Commercial Division)

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Article 2 applies to taxes on income and on capital. In this regard it is pertinent to note that it is immaterial which authority would levy the taxes or the mode of collection (i.e., direct assessment or deduction of tax at source). The intent is to identify the categories of taxes to which the Tax Treaty would apply.

Taxes on income and on capital as stated in the above paragraph, includes the following:

- Tax on total income;
- Tax on element of income
- Tax on capital;
- Tax on element of capital.

The Article also specifically states that it shall include taxes on profits or gains from alienation of movable or immovable property, tax on capital appreciation and tax on wages or salaries. However, contributions made towards social security or such other charges where there is direct connection between the levy and individual benefits to be received shall not be regarded as taxes as per the provisions of this Article.

The taxes covered in this Article include charges and duties accessory to the principal tax, such as, increases, cost, additional charges etc. However, practices among the contracting states differ with respect to interest and penalties leviable. Therefore, the contracting states would clarify this point in the bilateral negotiations²⁰.

Article 2 of the Tax Treaty also lists specific taxes in force at the time of entering into the Tax Treaty. The list is illustrative to the preceding paragraphs of the Article and is not intended to be an exhaustive list. However, the contracting states are expected to list all the taxes that are in force at the time of signing the tax treaties. At this point it is pertinent to note that certain countries may choose to list exhaustively, the taxes covered by the Convention. In that case, the Tax Treaty shall apply only to such taxes which are itemized.

Further, the Tax Treaties are required to be appropriately worded to include any subsequent changes in the domestic tax laws of the Contracting states. In other words, in order to guarantee comprehensive Treaty benefits, which normally extends its scope to cover identical or substantially similar taxes which are imposed after the Treaty has been signed, in addition to, or in place of the existing ones, to ensure that changes in tax laws will not result in a treaty becoming inoperative.

In continuation of above, Tax Treaties also contain a rule stating that the competent authorities of the contracting states shall notify each other of any significant changes in their taxation laws. If a country fails to notify any such changes in the tax laws to the other country, the new taxes would still come under the purview of the Treaty. The country which failed to make such notification cannot be denied the right to apply its changed domestic law. This is true not only with respect to express changes in domestic laws but also when cases substantially dealing

²⁰ Paragraph 4 to Article 2 of the Commentary to OECD MC

with interpretation of the law are adjudicated, subsequent to signing the Tax Treaty.

2.2 Analysis of the various model conventions

Article 2 of the OECD MC is reproduced in the United Nations Model Convention-2011 (“UN MC-2011”). Further, Article 2 of the US MC is also similarly worded except for a few changes and the same have been examined as follows.

Paragraph 1 of the OECD MC provides the scope of application of the Tax Treaty and reads as follows –

“This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.”

As quoted in the aforementioned paragraph, the Tax Treaty shall apply to taxes on income and on capital. It further elaborates that the taxes can be imposed by the contracting states including its political sub-divisions and local authorities and it is immaterial if the taxes are levied through direct assessment or through deduction of tax at source. The Tax Treaty only intends to clarify the categories of income to which it would apply.

Paragraph 1 of the US MC is based on the OECD MC and defines the scope of application of the Tax Treaty and as per the Technical Explanation to Article 2 of US MC, the Tax Treaty does not include taxes levied by the states or local authorities. Therefore, in effect the Tax Treaty would apply only to the Federal Income taxes imposed by the Internal Revenue Code.

Paragraph 2 of the OECD MC, reads as follows –

“There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.”

The commentary to the OECD MC states that Paragraph 2 of Article 2 of OECD MC provides definition of the term ‘taxes on income and on capital’. It includes taxes on total income and on elements of total income, on total capital and elements of capital. Taxes on elements of total income/capital include tax on dividend, interest and capital gains²¹. Paragraph 2 also includes taxes on alienation of movable and immovable property, on wages or salaries disbursed by enterprises and on capital appreciation. However, as per the commentary to US MC, Paragraph 2 does not include property taxes. Other charges such as social security charges where a direct nexus can be established towards the contribution and individual benefits received, the provisions of the Tax Treaty would not apply.

²¹ Cyril Eugene Pereira, In re (1999), 239 ITR 650

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Paragraph 3 of the OECD MC provides as follows:

'The existing taxes to which the Convention shall apply are in particular:

a) (in State A):

b) (in State B):'

It creates a provision for the contracting states to itemize the taxes in force at the time of entering into the Tax Treaty. The commentary to the OECD MC states that the list of taxes in force shall not be exhaustive but only an illustrative list to support the preceding Paragraphs of the Article. However, in principle it shall enumerate all the taxes to which the Tax Treaty applies, which are in force at the time of entering into an agreement.

Paragraph 3(b) of the US MC specifically states the taxes in force in the United States to which the Tax Treaty shall apply. They are as follows:

- Federal income taxes imposed by the Internal Revenue Code
- Federal excise taxes imposed with respect to Private Foundations

The US MC excludes social security and unemployment taxes from the purview of Taxes Covered under Article 2 of the Tax Treaty.

Paragraph 4 of the OECD MC, reads as follows –

"The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws."

Paragraph 4 of Article 2 to the OECD MC is phrased to accommodate any subsequent changes in the taxation laws of the contracting states. According to the commentary to the OECD MC, the Tax Treaty in effect would apply to all the taxes that are identical or substantially similar to the taxes in force at the time of entering into the Tax Treaty and this Paragraph is essentially included to avoid the necessity to conclude a new treaty every time the tax laws of the contracting states are amended. The Paragraph 4 of the US MC is also worded similarly.

2.3 Analysis of the India-USA Tax Treaty

Paragraph 1 of the India-USA DTAA is similar to Paragraph 3 of the Model Conventions and lists the taxes to which the provisions of the Tax Treaty shall apply. As per Article 2(1)(a) of the India-USA DTAA, only Federal income-tax as imposed by the Internal Revenue Code is covered in the Tax Treaty and does not cover State income-tax²². As for the Indian laws, the Tax Treaty shall apply only to Income-tax imposed under the Income-tax Act, 1961 and the surtax.

Also, please note that Paragraph 1 to Article 2 of India-USA DTAA specifically excludes

²²Manpreet Singh Gambhir v DCIT (2008) 26 SOT 208 (Delhi)

application of the Tax Treaty to amounts payable on default or omission to pay taxes specified in the preceding sub-paragraphs. The same is reproduced below –

“Taxes referred to in (a) and (b) above shall not include any amount payable in respect of any default or omission in relation to the above taxes or which represent a penalty imposed relating to those taxes”

On examining the above, it is clear that provisions of the India-USA DTAA shall not apply to the interest, penalties and other charges imposed by the respective Contracting States.

Paragraph 2 of the India-USA DTAA corresponds to the Paragraph 4 of the Model Conventions; to state that the Tax Treaty shall apply to any identical or substantially similar taxes imposed after the date of signature of the Tax Treaty, in addition to or in place of the existing taxes. Also, the contracting states undertake to notify each other, of any changes in the taxation or other laws affecting the Tax Treaty.

In this connection, it is pertinent to note that in the year 2004-05 on introduction of education cess under the Indian tax laws, a question arose that if education cess would fall within the scope of the taxes covered by the Tax Treaty, considering that it was not in force under the domestic tax laws at the time of signing the Tax Treaty. In this regard, education cess was regarded as a tax which is identical and substantially similar in nature to the existing list of taxes and accordingly is covered within the term “taxes” as per the Tax Treaty²³.

India-Hong Kong tax treaty

On 19 March 2018, India and Hong Kong Special Administrative Region of People's Republic of China (Hong Kong) signed a tax treaty. Taxes on income means all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of movable or immovable property and taxes on the total amounts of wages or salaries paid by enterprises. The tax treaty is applicable to existing taxes. In case of India, such tax is an income tax in India, including surcharge thereon. In case of Hong Kong, such taxes are profits tax, salaries tax, and property tax. The tax treaty shall also apply to any identical or substantially similar taxes that may be imposed in future. It does not include any penalty or interest or fine imposed under the domestic laws.

2.4 Judicial Precedents

(a) Article 2(3) of the OECD MC

The Courts have held that where certain tax has been included in Article 2(3) of a Tax Treaty of a country, merely for avoidance of doubt, does not imply that the tax is excluded from another Tax Treaty with another country which is silent in this regard²⁴.

²³DIC Asia Pacific Pte. Ltd. v. ADIT (2012) 147 TTJ 503 (Kol), DCIT v. BOC Group Ltd (2016) 156 ITD 402 (Mum)

²⁴IBFD Case No 99/15/0265 (Supreme Administrative Court of Austria)

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(b) Article 2(2) of the India-UAE DTAA

In the context of Article 2(2) of the India-UAE DTAA, the Authority for Advance Rulings ("AAR") held that the said treaty did not deal with any tax which was not in existence on the date of signing the Tax Treaty. The Government of India is not empowered to grant relief in the case of any potential liability for tax which is not in existence²⁵. However, the Supreme Court²⁶ has specifically referred to the decision of Cyril Eugene Pereira's and disapproved the reasoning/ratio mentioned therein. Merely because at the given time there is an exemption from income tax in respect of any particular head, it cannot be contended or held that the assessee is not liable to tax. The Supreme Court referred to the concept of "fiscal residence of a company" after making reference to OECD and UN MCs and interpretations placed by Courts in different countries and manuals of international taxation. It was observed that "liable to taxation" does not refer to current but also potential double taxation.

(c) Article 2(4) of the OECD MC

Article 2(4) supplements Article 2(3) and prevents a treaty from becoming inoperative if one of the contracting states modifies its tax laws²⁷. It ensures that a Tax Treaty has prospective effect²⁸.

(d) Imposition of identical taxes

The Courts have held that one should not be blinded by the mechanisms used to impose tax but this does not mean that when deciding if a tax is similar to another tax, the mechanisms of the earlier imposition are irrelevant.

(e) Imposition of new taxes

A new tax is 'substantially similar' to an existing tax where it has a material likeness or resemblance to the existing tax taking into account the essential elements of the tax, such as the base upon which it (ie, new tax) is imposed and the manner of computation. However, 'substantially similar does not mean identical'²⁹.

(f) Significant changes in the tax laws to be notified

The Courts have held that, the first sentence of Article 2(4) is a self-contained substantive provision, while the second sentence merely imposes a procedural requirement that is enlivened after the substantial change has been made. This procedural requirement goes to no more than an administrative convenience. Hence any non-compliance with the second sentence of Article 2(4) does not prevent the first sentence from operating according to its terms. Therefore, in effect the imposition of new or similar taxes will come into force immediately and the

²⁵ Cyril Eugene Pereira, In re (1999) 239 ITR 650

²⁶ UOI v. Azadi Bachao Andolan (2003) 263 ITR 706 (SC)

²⁷ IBFD Case No 6737 (Natal Income-tax Special Court)

²⁸ Kinsella v Revenue Commissioner (2007) IEHC 250 (Irish High Court: Commercial Division)

²⁹ ATO ID 2012/2, Virgin Holdings Sa v Federal Commissioner of Taxation (2008) FCA 1503 (Federal Court of Australia)

procedural compliance to intimating it to the Authorities of the other Contracting State does not hinder its application³⁰.

2.5 Conclusion

In conclusion, Article 2 provides for the terminology and nomenclature relating to the taxes covered by Tax Treaty in a more acceptable and precise manner to ensure the identification of taxes sought to be covered therein. It essentially attempts to broaden the applicability of a particular convention synchronising it with the domestic laws of the contracting states. Further it seeks to ensure that changes in the tax laws will not result in a treaty becoming inoperative.

3. Article 3 –General Definitions

Article 3 of the UN MC titled “General Definitions” is phrased as “For the purpose of this Convention, unless the context otherwise requires:.....”

As the title of this Article suggests, it spells out general definitions which are essential for the interpretation of the terms used in the Tax Treaties. It covers some of the general definitions such as national, a person, an enterprise, business etc. Whereas, the description for expressions in relation to specialised concepts are defined in their respective special Articles. On the other hand, terms which are not defined in the Tax Treaties shall have the meaning that it has under the tax laws of the State levying taxes under the Convention.

Further, Article 3 provides that the definitions are subject to, ‘unless the context otherwise requires’ which implies that if any term is not defined then unless the context otherwise requires, it will have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State. This condition allows flexibility in order to avoid results not intended by the Treaty’s negotiators³¹.

3.1 Analysis of Article 3(1)

3.1.1 Person

Article 3(1)(a) of the OECD / UN MC defines “person” as follows:

“The term ‘person’ includes an individual, a company and any other body of persons.”

The definition is not exhaustive and should be read as indicating that the term ‘person’ is used in a very wide sense³². The definition explicitly includes individuals, companies and any other body of persons. This definition is important for many reasons. For example:

- Article 1 provides that the treaty applies to “persons” who are residents of one or both contracting states.
- Article 4 provides that the eligibility to claim most of the benefits under the Tax Treaties

³⁰ Undershaft (No 1) Ltd v Commissioner of Taxation (2009) FCA 41

³¹US Model Commentary (2006)

³²OECD Commentary (2010) para 2

is available to a resident of a Contracting State and only a “person” qualifies as a resident.

- Only “persons” are eligible to claim relief under Article 25 (Mutual Agreement Procedure).

The definition of the term “Company” in subparagraph (b). means any body corporate or an entity that, although not incorporated, is treated as a body corporate for tax purposes. Partnerships also come within the purview of the term ‘person’ either by way of being classified as a company or because they constitute ‘other bodies of persons’.

Article 3(1)(a) of the US MC defines “person” as *“The term ‘person’ includes an individual, an estate, a trust, a partnership, a company and any other body of persons.”*

As is evident from the above, the US MC provides more inclusions in the definition of a ‘person’.

3.1.2 Judicial Precedents

- In the case of Abdul Razaq A Meman³³, the Authority for Advance Ruling held that the term person includes natural as well as artificial persons.
- In Linklaters LLP v ITO³⁴, the Tribunal ruled that although a partnership firm is fiscally transparent in UK, it is a ‘person’ since it is treated as taxable entity under the Indian tax law.
- The Calcutta High Court, in the case of P & O Nedlloyd Ltd. & Ors³⁵ held that the tax treaty benefit is available to a UK partnership firm. The Supreme Court dismissed revenue’s Special Leave Petition (SLP) against Calcutta High Court decision.
- On 30 October 2012, a protocol was introduced under the India-UK DTAA to provide that the tax treaty benefits shall apply to income derived by a partnership firm, to the extent that such income is taxed in the UK in its hands or in the hands of its partners. However, the term ‘person’ does not specifically include partnerships. The CBDT clarified³⁶ that the provisions of the tax treaty would be applicable to a partnership that is a resident of either India or the UK, to the extent that the income derived by such partnerships, estate or trust is subject to tax in that state as the income of a resident, either in its own hands or in the hands of its partners or beneficiaries.
- Many of India’s treaties do not contain specific provisions that deal with availability of treaty benefits to entities that are treated as fiscally transparent in their country of formation. The Multilateral Instrument (MLI) signed by India contains an Article relating to Fiscally Transparent Entity. Under MLI, Article 3 provides that income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either contracting jurisdiction shall be considered to be income of a resident of a contracting jurisdiction but only to the extent that the income is treated, for purposes of taxation by that contracting jurisdiction, as the income of a resident.

³³276 ITR 306 (AAR) (2005)

³⁴132 TTJ 20 (Mum) (2010)

³⁵52 taxmann.com 468 (Cal) [2014]

³⁶Circular No. 2/2016, dated 25 February 2016

- However, the same is not a minimum standard. Signatories to the MLI have the option of not applying this to their respective treaties. Pursuant to this, India has indicated that it will not apply this Article to any of its Covered Tax Agreements. Hence, this provision does not affect any of India's tax treaties.

3.1.3 Company

Article 3(1)(b) of the OECD / UN MC defines "company" as follows *"The term 'company' means anybody corporate or any entity that is treated as a body corporate for tax purposes."*

Any body-corporate created under the law of any country is a company and consequently a person under the MC. Additionally, it also includes an unincorporated entity (eg, trust, foundation, partnership) only if the same is treated as a body corporate for tax purposes.

Article 3(1)(b) of the US MC defines "company" as follows *"The term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes according to the laws of the state in which it is organized."*

Reference to definition used in treaties signed by India and as per the Act (if any)

In general, Tax Treaties define "Company" as *"anybody corporate or any entity which is treated as a company or body corporate for tax purposes"*

Whereas as per section 2(17) of the Act;

"company" means—

- (i) any Indian company, or*
- (ii) anybody corporate incorporated by or under the laws of a country outside India, or*
- (iii) any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 (11 of 1922), or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April, 1970, or*
- (iv) any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company :*

Provided that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April, 1971, or on or after that date) as may be specified in the declaration"

Judicial Precedents

- In certain cases³⁷, it has been held that a body corporate retains its character as a

³⁷IBFD Case No 2 K 2100/03 (Tax Court of First Instance of Germany); IBFD Case No 1 R 39/07 (Federal Tax Court, Munich); TD Securities (USA) LLC v Her Majesty the Queen (2010) IBFD Case No 2008-2314(IT)G (Tax Court of Canada)

“Company” even if it is fiscally transparent in the country of its formation.

- In *Population Council Inc, In re*³⁸, the Revenue accepted before the AAR that an international non-profit, non-governmental organisation, incorporated under the New York Membership Corporation Law, is a “company” under Article 3(1)(f) of the India-US DTAA.

3.1.4 Enterprise

Article 3(1)(c) and 3(1)(d) of the OECD MC and the UN MC respectively, define “enterprise” as follows:

“The term ‘enterprise’ applies to the carrying on of any business.”

The UN MC does not contain a definition for the term “enterprise”. In common parlance, enterprise means an economic activity carried on by a person capable of producing profits. Internationally, however, the Courts have held that the term ‘enterprise’ includes industrial, commercial and other enterprises.

The questions whether an activity is performed within an enterprise or is deemed to constitute in itself, an enterprise has always been interpreted according to the provisions of the domestic tax laws of the Contracting States³⁹. However, it would be important to note that the performance of professional services or other activities of an independent character would constitute an enterprise irrespective of the meaning of that term as per the domestic laws. This is due to the reason that enterprise is defined as carrying on of any business and the term business has been explicitly defined to include the performance of professional services and of other activities of an independent character.

Judicial Precedent

- The Federal Tax Court⁴⁰, Munich held that an interest of a Swiss partner in a “fiscally transparent” German partnership constituted a Swiss enterprise under the Germany-Switzerland Tax Treaty (1971).

3.1.5 Enterprise of a Contracting State and Enterprise of the other Contracting State

Article 3(1)(d)/ 3(1)(c) of the OECD and the UN MC respectively, defines “enterprise of a Contracting State” and “enterprise of the other Contracting State” as follows:

“The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State.”

The above mentioned subparagraph is self-explanatory. However, it could be noted that the residency of the enterprise depends on the residential status of the person carrying the enterprise and not the place from which the enterprise is carried on. For example, a US

³⁸286 ITR 243 (AAR) (2006)

³⁹OECD Commentary (2010) para 4; UN Commentary (2011) para 6

⁴⁰Case no I R 63/06

corporation doing all its business in India will still be a US enterprise⁴¹.

Article 3(1)(c) of the US MC defines “enterprise of a Contracting State” and “enterprise of the other Contracting State” as follows:

“The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State; the terms also include an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State.”

Subparagraph 1(c) of the US model further makes a statement to clarify that an enterprise conducted by a fiscally transparent entity will be treated as carried on by a resident of a Contracting State, to the extent its partners or other owners are residents of that Contracting State. This is because, the benefits from the provisions applicable to enterprises of a Contracting State could be withdrawn from such entities on the reasoning that such an entity is not conducted by a resident of a Contracting State

Reference to definition used in treaties signed by India and as per the Act (if any)

The India-USA / France / Germany and other treaties define the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" to *“mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State”*

3.1.6 International traffic

Article 3(1)(e)/ 3(1)(d) of the OECD and the UN MC respectively, defines “international traffic” as follows:

“The term ‘international traffic’ means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State”

The definition is primarily important in connection with taxation of profits made by the enterprises engaged in transportation business as defined in Article 8. The definition of the term “international traffic” is to be comprehended in a wide sense to mean that the State in which the enterprise has its place of effective management, has the right to tax its domestic traffic as well international traffic between third States, whereas the other Contracting State is permitted to tax traffic exclusively within its borders.

For example, say an enterprise ‘E’ has its place of effective management (in State A), sells tickets for a passage confined within State A or alternatively within a third State (State C), through an agent in the other Contracting State (State B). In the given situation, the above mentioned subparagraph implies that State B does not have the authority to tax the profits of either voyage engaged by enterprise E. State B can tax the profits of enterprise E only if the

⁴¹US Model commentary (2006)

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operations are confined solely to places in State B⁴².

The definition also states that a transport by ship or aircraft will not be considered as “international traffic” if the ship or aircraft is operated solely between places in the other Contracting State. For example, where Enterprise E having its place of effective management (in State A), operates its ship or aircraft solely between two places in the other Contracting State (State B), or even if part of the transport takes place outside the State, it will not be considered as “international traffic”⁴³.

The update to OCED MC 2017 amended the definition to provide that the term ‘international traffic’ means any transport by a ship or aircraft, except when the ship or aircraft is operated solely between places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State.

Article 3(1)(f) of the US MC defines “international traffic” as follows:

“The term ‘international traffic’ means any transport by a ship or aircraft, except when such transport is solely between places in a Contracting State.”

The US MC refers, in the definition of “international traffic,” to “such transport” being solely between places in the other Contracting State, while the OECD / UN MC refers to the ship or aircraft being operated solely between such places. The US MC language is intended to make clear that, even if the goods are carried on a different aircraft for the internal portion of the international voyage and then is used for the overseas portion of the trip, the definition applies to that internal portion as well as the external portion⁴⁴.

Reference to definition used in treaties signed by India and as per the Act (if any)

The general definition of the term “International Traffic” in treaties signed with USA / France / Germany / Japan is *“the term “international traffic” means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places within the other Contracting State”*.

This term finds reference only in the Tax Treaties, apt for the circumstances covered by the same.

Judicial Precedents

- In *Essar Oil Ltd vs DCIT*⁴⁵, the Tribunal held that, even if a ship in the course of its voyage in international traffic, ports between two ports in another country, such operation does not cease the voyage to be in international traffic and does not convert into coastal traffic. It still remained in international traffic. For the purpose of qualifying a voyage as coastal traffic, the voyage must begin and must end within the coastal waters of a particular state. In the present case, the facts were that the ship was proceeding from Singapore to

⁴²OECD Commentary (2010) para 6

⁴³OECD Commentary (2010) para 6.1; US Model Commentary (2006)

⁴⁴US Model Commentary (2006)

⁴⁵102 TTJ 614 (Mum) (2006)

Arabian Gulf and on its way through the international waters, had operated certain tasks in Indian ports and the voyage commenced in Singapore and India in Arabian Gulf and the stay of the ship in Indian waters was for a period of 10 days only and, therefore, in the light of all these facts, it is necessary to hold that the ship was operating in international traffic and, therefore, income, if any, arising out of the present case would be taxable only in Singapore and not in India”

Therefore, from the above decision it can be concluded that despite a foreign ship sailing through international waters and which crossovers to another State for random business operations, still qualifies as international traffic, as the ship did not operate in between the Indian ports exclusively.

- In *APL Co Pte Ltd vs DDIT*⁴⁶, the Tribunal held that, given the facts of the case where the Singaporean company, in the business of sea faring cargo business having tax base at Singapore, entered into joint service agreement with vessel operators for slot allocation in the feeder vessels for carrying the cargo from the Chennai port to its hub either at Singapore or Sri Lanka, from where the cargo was loaded into the mother vessel for its destination port (outside India), the ship is still considered to be operating in “international traffic”.
- With regard to the usage of the word “places” in the definition of the term “international traffic” – the term “places” signifies specific physical locations, such as harbours, ports, safe anchorages, airports and landing strips⁴⁷. Also, “places” does not include broad concepts such as 'international airspace' or 'international waters', as these are not specifically identifiable locations that refer to a particular area occupied by a person or thing⁴⁸.

3.1.7 Competent authorities

Article 3(1)(f)/ 3(1)(e) of the OECD and the UN MC respectively, defines “competent authority” as follows:

“The term ‘competent authority’ means:

- (i) (In State A):
- (ii) (In State B):

The competent authorities are those bodies of each contracting state which are vested with the authority to determine issues relating to the convention in particular under the Mutual Agreement Procedures (Article 25) and the Exchange of information (Article 26). The definition has regard to the fact that under certain treaties execution does not exclusively fall within the jurisdiction of the highest tax authorities. Where the jurisdiction on some matters are reserved for or delegated to other authorities this definition enables each country to a Treaty to nominate one or more

⁴⁶2013-TII-76-ITAT-MUM-INTL

⁴⁷ATO TR 2008 / 8 (para 133)

⁴⁸ATO TR 2008 / 8 (para 134, 135)

authorities as being competent to determine issues relating to the convention. In India, the competent authority is the Ministry of Finance (Department of Revenue) or their authorised representative. Article 3(1)(g) of the US MC defines “competent authority” as follows:

“The term ‘competent authority’ means:

- (i) in.....; and*
- (ii) in the United States: the Secretary of the Treasury or his delegate.”*

In case of the US MC, it specifically defines who the competent authority in the US is. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue⁴⁹.

Reference to definition used in treaties signed by India and as per the Act (if any)

The term Competent Authority in relation to India has been defined in most of the treaties signed with India to mean “*the Central Government in the Ministry of Finance (Department of Revenue) or their authorised representative*”.

However, this term has not been defined in the Act.

3.1.8 National

Article 3(1)(g) / 3(1)(f) / 3(1)(j) of the OECD/ UN/ US MC respectively, defines “national” as follows:

- “(i) any individual possessing the nationality or citizenship of that Contracting State; and*
- (ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State”*

The definition of national is primarily relevant to Article 24 dealing with non-discrimination. The usage of the word citizenship has been particularly excluded in Article 3(1)(f) of the UN MC and the US MC uses only the words State instead of Contracting State. The meaning of the term “national” depends on the sense in which the term is used and also on the rules pertaining to acquisition or loss of nationality / citizenship adopted by each Contracting State.

With respect to legal persons, partnerships or association, their nationality depends on the laws in force in that respective Contracting State. Further, the distinct mention of partnership is necessary to avoid confusion as some domestic laws may categorise an entity as a ‘person’ but not a ‘legal person’ for tax purposes⁵⁰.

Judicial Precedent

- In *Chohung Bank v DDIT*⁵¹, the Tribunal held that where Article 3(1)(g) of the India-Korea Tax Treaty (1985) defines “national” as “any individual possessing the nationality of a Contracting State and any legal person, partnership, association or other entity deriving

⁴⁹US Model Commentary (2006)

⁵⁰ OECD Commentary (2010) para 10.1

⁵¹6 SOT 144 (Mum) (2006)

its status as such from the laws in force in the Contracting State.”, the words “other entity” does not include corporate bodies unless they are declared “nationals” under the laws of those States.

3.1.9 Business

Article 3(1)(h)/ 3(1)(e) of the OECD/ US MC respectively, defines “business” as follows:

“The term “business” includes the performance of professional services and of other activities of an independent character.”

In case of the OECD model, it earlier contained an article dealing with Independent Personal Services but was subsequently deleted in 2000 based on Technical Group report which mentioned that Article 14 serves no purpose and same can be covered in Article 7. Hence, the term business was specifically defined to ensure that it is not construed in a restricted manner so as to not include the performance of professional services, or other activities of an independent character, in States where performance of such services or activities does not come within the purview of the term ‘business’ as per their domestic laws.

3.1.10 United States

Article 3(1)(i) of the US MC defines “United States” as follows:

“the term “United States” means the United States of America, and includes the states thereof and the District of Columbia; such term also includes the territorial sea thereof and the sea bed and subsoil of the submarine areas adjacent to that territorial sea, over which the United States exercises sovereign rights in accordance with international law; the term, however, does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory.”

For certain purposes, the term “United States” includes the sea bed and subsoil of undersea areas adjacent to the territorial sea of the United States. This extension applies to the extent that the United States exercises sovereignty in accordance with international law for the purpose of natural resource exploration and exploitation of such areas⁵². This extension would not include any activity involving the sea floor of an area over which the United States exercised sovereignty for natural resource purposes unless that activity is related to the exploration and exploitation of natural resources.

3.1.11 Pension Fund

Article 3(1)(k) of the US MC defines “pension fund” as follows:

“the term “pension fund” means any person established in a Contracting State that is:

- i) generally exempt from income taxation in that State; and*
- ii) operated principally either:
 - A) to administer or provide pension or retirement benefits; or**

⁵²US Model Commentary (2006)

- B) *to earn income for the benefit of one or more persons described in clause A).*”

Subparagraph (k) defines the term "pension fund" to include any person established in a Contracting State that is generally exempt from income taxation in that State and that is operated principally to provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements⁵³.

On February 29, 2016, OECD released discussion draft on the treaty residence of pension funds as per BEPS Action Plan 6.

This discussion draft included changes to Article 3 (relating to General definitions), and proposes to modify Para 1 of Article 4 (which defines the term "resident of a contracting state"), to specifically include 'a recognised pension fund of that State'. The draft also included changes to the Commentary on these Articles, so as to ensure that a pension fund is considered to be a resident of the State in which it is constituted for the purposes of tax treaties.

The 2017 OECD MC update has amended the definition of a 'resident' to specifically include a 'recognised pension fund' which is also specifically defined to mean 'an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:

- (i) that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or
- (ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in (i).

Subparagraph (ii) of the above definition covers entities or arrangements that pension funds covered by subparagraph (i) use to invest indirectly. Pension funds often invest together with other pension funds pooling their assets in certain entities or arrangements and may, for various commercial, legal or regulatory reasons, invest via wholly owned entities or arrangements that are residents of the same State. Since such arrangements and entities act only as intermediaries for the investment of funds used to provide retirement benefits to individuals, it is appropriate to treat them like the pension funds that invest through them.

However, India reserves the right not to include subparagraph (ii) of the above definition of 'recognised pension fund'.

3.2 Analysis of Article 3(2)

Article 3(2) of the OECD/ UN/ US MC, reads as follows:

“As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies,

⁵³US Model Commentary (2006)

any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.”

The US MC additionally contains the words “*or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure),*” after the words ‘unless the context otherwise requires’.

Paragraph 2 essentially implies that if any term used in the Tax Treaty is not defined therein, then its meaning can be adopted from the meaning assigned to such a word under the domestic law of the Contracting State in which tax is being levied. If however, such a term is defined in both the tax and non-tax laws of a Contracting State, the definition provided in the tax law has to be considered for the purpose of application of Article 3(2).

Moreover, in circumstances where multiple definitions are provided for a term in the tax laws of a State, the definition used for purpose of the particular provision at issue, if any, should be used⁵⁴. The US MC article also implies that in order to prevent double taxation or for any other purpose of the Tax Treaty, the competent authorities, as specified in Article 25 (Mutual Agreement Procedure), may establish a common meaning, if the meaning of a term cannot be easily inferred under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Tax Treaty. However, this common meaning need not be in accordance with the meaning of the term under the laws of either Contracting State⁵⁵.

When the internal law of a Contracting State is being referred to for the purpose of Paragraph 2, it implies that the law in effect at the time the treaty is being applied is to be referred (ie, ambulatory or dynamic rule), and not the law as in effect at the time the treaty was signed (ie, static rule). Further, Paragraph 2 also contains the statement “unless the context otherwise requires” which entails that the provisions of Paragraph 2 will not apply if the context requires an alternative interpretation. The context here refers to the intention of the Contracting States when signing the Tax treaties as well as the meaning assigned to the term under the domestic laws of the other Contracting State (i.e., the principle of reciprocity).

The update to OCED MC 2017 provides that as regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies.

It would be imperative to note that, in the context of India, Section 90(3) of the Act provides that “*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.*”

⁵⁴US Model Commentary (2006)

⁵⁵US Model Commentary (2006)

Sub section (1) of Section 90 of the Act refers to the Tax Treaties entered into by the Central Government with the Government of various countries outside India or also the specified territory outside India (ie, the Tax Treaties).

As per Article 3(2) definition under the domestic law is to be adopted only if it is in the right context. Thus, it could happen that particular term used in the Tax Treaty is defined in the Act in a different context and hence, does not pass the test of Article 3(2). As per section 90(3) of the Act, a term not defined under the tax treaty or the Act may be assigned a meaning vide a notification and the same can be applied provided it is in the right context and it is not inconsistent either with the provisions of the Act or the Tax Treaties. However, if such a term is defined under the Act, although in a different context, it may not be possible to notify a meaning with regard to such a term.

The Finance Act, 2012 has also introduced an explanation to Section 90 of the Act, with retrospective effect from 1 October 2009, which reads as under:

“Explanation 3 – For the removal of doubts, it is hereby declared that where any term is used in any agreement entered into under sub-section (1) and not defined under the said agreement or the Act, but is assigned a meaning to it in the notification issued under sub-section (3) and the notification issued thereunder being in force, then the meaning assigned to such term shall be deemed to have effect from the date on which the same agreement came into force.”

This Explanation has inbuilt retrospective mechanism according to which, the meaning given in the notification will be deemed to have effect from date of coming to force of the Tax Treaty. As per the Explanatory Memorandum, the rationale of such inbuilt retrospective mechanism is that the meaning of a term as understood during the negotiation stage is to be adopted (termed static approach) and hence the meaning needs to be adopted from the date the Treaty becomes operational.

Tax treaties signed by India with certain countries such as Armenia, Hungary, Kazakhstan, Portugal, South Africa, Sudan etc, specifically adopt ambulatory approach (as per Article 3 of the respective Tax Treaties) i.e., term not defined under the Tax Treaty should be given a meaning as per the domestic tax law prevalent at the relevant point of time. Hence, the amendment to section 90(3) may be considered to be in conflict with the provisions of such Tax Treaties.

Certain terms such as “liable to tax”, “make available”, “copyright” etc. are generally not defined in all the Tax Treaties. Also, terms like “managerial services” “consultancy services”, “technical services” etc. are not defined in the domestic tax law.

The Income-tax simplification committee in its final report has suggested to bring in more clarity in the Act in respect of interpretation of 'terms' used in an agreement entered under section 90 or 90A for the purposes of its application in order to reduce the avoidable litigation related to taxation of non-residents. In the light of above discussion and to bring in clarity to avoid litigation the Finance Act, 2017 introduced Explanation 4 to Sections 90 and 90A of the Act, to provide that where any 'term' used in an agreement entered into under sub-section (1) of Section 90

and 90A of the Act, is defined under the said agreement, the said term shall be assigned the meaning as provided in the said agreement and where the term is not defined in the agreement, but is defined in the Act, it shall be assigned the meaning as definition in the Act or any explanation issued by the Central Government.

3.2.1 Judicial Precedents

- The Supreme Administrative Court of Austria⁵⁶ held that, even if Article 3(2) is absent in a particular Treaty, reference could be made to the domestic law for understanding the meaning of an undefined expression in the treaty.
- In *Hindalco Industries Ltd vs ACIT*⁵⁷, the Tribunal has upheld few of the following principles:
 - The provisions of the Treaty are to be given effect to in their context and in the light of the object and purpose of the Treaty.
 - Even when connotations of a Treaty term are to be adopted as per the domestic law in the country of taxability, it cannot be done so as a thoughtless and mechanical process.
 - The meaning of the undefined terms in a Tax Treaty should be determined by reference to all of the relevant information and all of the relevant context. There cannot, however, be any residual presumption in favour of a domestic law meaning of a treaty term.
- The Delhi High Court in the case of *New Skies Satellite BV*⁵⁸ observed as follows:
 - The Parliament is simply not equipped with the power to, through domestic law, change the terms of a treaty. A treaty is not drafted by the Parliament; it is an act of the executive.
 - Mere amendment to Section 9(1)(vi) of the Act cannot result in a change. It is imperative that such amendment is brought about in the tax treaty as well.

3.2.2 Analysis of certain definitions used in treaties signed by India

❖ India

In some of the treaties signed by India with the other countries, the term “India” has been defined in a similar fashion. For example in treaties signed between India and US/ France / Australia, the term “India” is defined as follows”

“the term "India" means the territory of India and includes the territorial sea and air space above it, as well as any other maritime zone in which India has sovereign rights, other rights and jurisdictions, according to the Indian law and in accordance with inter-national

⁵⁶BFD Case No 2002/15/0098

⁵⁷94 TTJ 944 (Mum) (2005)

⁵⁸[ITA 473/2012] (Del)

law”

However, as per section 2(25A) of the Income-Tax Act, 1961 (“the Act”), the term India is defined as *“the territory of India as referred to in article 1 of the Constitution, its territorial waters, seabed and subsoil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 (80 of 1976), and the air space above its territory and territorial waters”*

The definition as per the Tax Treaties was wider in scope and therefore in order to provide a comprehensive definition for the term “India” the definition was amended by the Finance Act, 2007 to align with Tax Treaty.

❖ **Contracting State**

The term “Contracting States” and the “other Contracting State” generally means India or the ‘respective State’ as the context requires. The India-Australia DTAA however specifically states that it ‘means as the context requires, Australia or India, the Governments of which have concluded this Agreement’.

❖ **Tax**

The term “tax” is not defined in either the OECD / UN or US MCs, however, many of the Tax Treaties define the above mentioned term.

While some of the Tax Treaties such as India-US / France / Japan define “tax” as *“Indian tax or ‘respective State’ tax, as the context requires”*, there are many other treaties like India-Mauritius / Netherlands / South Africa which defines the “tax” as *“Indian tax or ‘respective State’ as the context requires, but shall not include any amount which is payable in respect of any default or omission in relation to the taxes to which this Convention applies or which represents a penalty imposed relating to those taxes”*

Under Revised India-Korea DTAA, the term ‘tax’ has been clarified to exclude any amount payable in respect of any default or omission in relation to the taxes to which the tax treaty applies, or a penalty or fine imposed in relation to those taxes.

The Tribunal⁵⁹ held that, *“a bare reading of the definition of ‘tax’ shows that the term tax shall not include the amount which is payable in respect of default or omission in relation to taxes to which the convention applies. A close reading of the above would reveal that the amount which is excluded from the term ‘tax’ must be the amount which is payable under laws of either State; that such amount must be payable on account of default or omission by the assessee; and that such default or omission must relate to the taxes to which convention applies. All these conditions are cumulative and, therefore, must be satisfied.*

Therefore, the default or omission are restricted to those which are related to tax and, therefore, scope of default or omission cannot be extended to default or omission qua the provisions

⁵⁹ DDIT v Sun Chemicals BV 24 SOT 199 (Mum) (2008)

relating to the determination of total income of an assessee including determination of the Arm's length Price ("ALP") under Chapter X. Thus, the default or omission mentioned in the above definition would or may include the amount of interest payable by an assessee on account of non-payment of taxes. The words 'shall not include any amount which is payable' are of utmost importance. The provisions of sections 92 to 92F do not relate to any amount payable by the assessee either by way of tax or 'interest' or penalty. All these provisions relate to the determination of ALP of international transactions. Therefore, the default, if any, relating to the provisions of sections 92 to 92F would not be covered by the default or omission mentioned in article 3(d)".

The term has also been defined specifically under section 2(43) the Act as *"'tax' in relation to the assessment year commencing on the 1st day of April, 1965, and any subsequent assessment year means income-tax chargeable under the provisions of this Act, and in relation to any other assessment year income-tax and super-tax chargeable under the provisions of this Act prior to the aforesaid date and in relation to the assessment year commencing on the 1st day of April, 2006, and any subsequent assessment year includes the fringe benefit tax payable under section 115WA"*

3.2.3 Reference in the Protocols signed by India with various countries

A protocol in essence is a Treaty entered into between two countries at a later point of time, which nevertheless forms an essential part of the Tax Treaty and can be referred to while applying the earlier treaty entered into between the countries.

Reference to a few of the protocols entered into by India with respect to Article 3 are provided below:

- In case of the treaties signed between India and China / Japan / Spain / Turkey, the term "Tax" is defined as *"Indian tax or 'respective State' tax, as the context requires."*

Whereas, the India-China protocol states that *"It is understood that the term "tax" should not include any penalty imposed for noncompliance of the laws and regulations relating to the taxes to which this Agreement applies"* and the protocol with the other States duplicates the definition of tax which has been directly provided for in some of the original treaties entered into, as discussed earlier.

Hence, it is clear that when referring to the definition of the term "tax", it has to be in read in conjunction with the reference provided for in the respective protocols. In the given instance, it implies that where any amount is paid due to a default or omission in relation to the taxes to which the Treaty applies or where the amount represents a penalty in relation to such taxes, the same will not come within the purview of the term "tax".

- In case of the India-Japan Treaty, Article 3(e) of the Treaty provides that the *"term 'person' includes an individual, a company and any other body of persons"*. Whereas, the protocol provides that *"the term person also includes a partnership and a Hindu undivided family"*.
- Similarly, in the case of India-Saudi Arabia Treaty, Article 3(d) provides that *"the term*

‘person’ includes an individual, a company, any other body of persons”, while the protocol states that “the term ‘person’ shall include the state, its political subdivision or local authorities and any other entity which is treated as a taxable unit under the taxation laws in force in the respective Contracting States.”

3.3 Conclusion

Article 3 provides definitions for certain general terms used in Tax Treaties. In addition, it also lays down the rules and method of determining the meaning of those terms which are not defined in the Tax Treaties.

4. Article 4 –Resident

4.1 Background

Article 4 plays a significant role in determining the scope of application of the Convention and helps in avoiding juridical double taxation in many situations. Double taxation is, generally, by way of taxation of the same income in the hands of the same person in two different tax jurisdictions. A person whose income is subjected to such double taxation can mitigate it through access to the Tax Treaty between the two Contracting States. In this regard, the primary condition for accessing the Tax Treaty is residence of a person as per the fiscal laws and hence the concept of residence assumes tremendous importance.

Article 4 of the OECD, UN and US MCs; provide the definition of the term ‘resident of Contracting State’. It is an exhaustive definition, which determines the applicability or non-applicability of a Tax Treaty to the person.

The concept of ‘resident of a Contracting State’ has various functions and assumes significance in the following three scenarios:

- In determining a convention’s scope of application;
- In solving cases where double taxation arises as a consequence of double residence;
- In solving cases where double taxation arises as a consequence of taxation in the state of residence and also in the state of source of income⁶⁰.

4.2 Resident as per the Indian Laws

Section 6 of the Income tax Act, 1961 (“the Act”) defines the term ‘resident’ and the relevant provisions of section 6 are discussed below.

4.2.1. Individual

For Individuals

- a. Present in India for 182 days or more; or

⁶⁰ Para 1 to Article 4 of the OECD Commentary

- b. ** (this clause is omitted)
- c. Within four years preceding that year, been in India for 365 days or more and in the previous year, been in India for 60 days⁶¹ or more.

Explanation 1 to section 6(1)

Explanation 1(b) to section 6 provides that in respect of an Indian citizen and a person of Indian origin who visits India during the year, the period of 60 days as mentioned in (b) above shall be substituted with 182 days. Explanation 1(a) to section 6 also provides similar concession to the Indian citizen who leaves India in any previous year as a crew member or for the purpose of employment outside India

The Finance Bill, 2020 (as presented on 1st February 2020) proposed an amendment to the Explanation 1(b) that the concession in the period of stay in India, for an Indian citizen and a person of Indian origin, shall be reduced from 182 days to 120 days. Further, at the time of enactment, Finance Act has restricted the application of amended provisions of Explanation 1(b) only to that Indian citizen or a person of Indian origin whose total income, other than income from foreign sources, exceeds Rs. 15 lakhs during the previous year. For this provision, income from foreign sources means income which accrues or arises outside India (except income derived from a business controlled in or a profession set up in India).

Explanation 2 to section 6(1)

CBDT, vide its notification dated 17th August, 2015 has issued a Notification “S.O. 2240(E)” as per the powers conferred under section 295 of Act. It has been specifically provided that the period of 182 days or more in the case of individual being Indian citizen and a member of crew ship, the period or periods of stay shall not include period beginning from the date entered into the Continuous discharge certificate⁶² in respect of joining the ship by such individual till the date entered into the continuous discharge certificate in respect of signing off by that individual from the ship in respect of such eligible voyage⁶³.

Deemed Residency Rule introduced by Finance Act 2020

Finance Act 2020 has introduced a new section 6(1A) in the Act. As per the said section, an individual, being a citizen of India, having total income, other than the income from foreign sources, exceeding fifteen lakh rupees during the previous year, shall be deemed to be resident in India in that previous year, if he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature.

⁶¹ In case of Indian citizen or person of Indian origin who leaves India for the purpose of employment outside India or coming on a visit to India the words sixty (60) shall be substituted with one hundred eighty two (182) days

⁶² Meaning as assigned to it under Merchant Shipping Rules, 2001 made under the Merchant shipping Act

⁶³ As per Rule 126 of the Income Tax Rules, voyage undertaken by a ship engaged in carrying of passengers or freight in international traffic where voyage originated from any port in India has its destination as any port outside India and vice versa.

Interim relief due to COVID-19 for PY 2019-20 in respect of residency under section 6 of the Act

The CBDT vide circular 11/2020 issued dated 8th May, 2020 relaxed the provision of Section 6 of the Act for residency of a person who had come on a visit to India during the previous year 2019-20 for a particular duration and intended to leave India before the end of the previous year for maintaining their status as non-resident or not ordinary resident in India. However, due to declaration of the lockdown and suspension of international flights owing to outbreak of Novel Corona Virus (COVID-19), they are required to prolong their stay in India.

For the purpose of determining the residential status under section 6 of the Act during that PY in respect of an individual who has come to India on a visit before 22nd March, 2020 and:

- (a) has been unable to leave India on or before 31st March, 2020, his period of stay in India from 22nd March, 2020 to 31st March, 2020 shall not be taken into account; or
- (b) has been quarantined in India on account of Novel Corona Virus (Covid-19) on or after 1st March, 2020 and has departed on an evacuation flight on or before 31st March, 2020 or has been unable to leave India on or before 31st March, 2020, his period of stay from the beginning of his quarantine to his date of departure or 31st March, 2020, as the case may be, shall not be taken into account; or
- (c) has departed on an evacuation flight on or before 31st March, 2020, his period of stay in India from 22nd March, 2020 to his date of departure shall not be taken into account.

4.2.2. Company

According to section 6(3) of the Act, a company is a resident of India, if –

- i. It is an Indian Company; or
- ii. The company's place of effective management (POEM), in that year, is in India.

Further, as per the explanation to section 6(3) of the Act, 'place of effective management' means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity, as a whole are, in substance made.

CBDT has issued⁶⁴ the guiding principles to be followed for determination of POEM. Key features of the guiding principles are as follows:

- The guidelines provide guidance on 'income', 'value of assets', 'number of employees' and 'payroll' in context of determining 'active business outside India'.
- The guidelines are primarily based on the fact as to whether or not the company is engaged in 'active business outside India'. For determination of 'active business outside

⁶⁴CBDT Circular No. 06/2017, dated 24 January 2017

India' factors such as passive income, total asset base, the number of employees, payroll expenses in India and outside, etc. are considered.

- The guidelines state that the concept of POEM is one of substance over form.
- It also deals with the impact of modern technology in POEM determination.
- These guidelines are not intended to cover foreign companies or to tax their global income, merely on the ground of presence of a PE, a foreign company completely owned by an Indian company, some of the directors are resident in India, etc.
- An exception has been provided for 'interest' income earned by banking companies/Public Financial Institutions (PFIs). Accordingly, any income by way of interest earned by banks/PFIs shall not be considered as passive income.
- The guidelines provide certain illustrations to provide clarity on various aspects.
- The guidelines provide that the AO would seek prior approval of the Principal Commissioner or the Commissioner before initiating any proceedings. The AO shall also obtain approval from Collegium of Principal Commissioners of Income-tax before holding that POEM of a non-resident company is in India.
- It has been clarified that the principles for determining the POEM are for guidance only and a 'snapshot' approach is not to be adopted.

Subsequent to issue of the above guidelines, the CBDT has also issued certain clarifications as mentioned hereunder:

- Vide Circular No. 8 of 2017 dated 23rd February 2017, it was clarified that the POEM provisions shall not apply to a company having turnover or gross receipts of Rs. 50 Crore or less in a financial year.
- Vide Circular No. 25/2017 dated 23rd October 2017, it was clarified that merely because the regional headquarter operates for subsidiaries / group companies in a region with general and objective principles of global policy of the group laid down by the parent entity in the field of pay roll functions, Accounting, Human resource (HR) functions etc. not being specific to any entity or group of entities per se; would not itself constitute a case of BoD of companies standing aside for the purpose of constituting POEM. Further, such activities of regional headquarter in India will not be a basis for establishment of POEM for such subsidiaries / group companies.

In this context, it would be pertinent to note that Finance Act, 2016, inter alia, introduced special provisions (vide Chapter XIIBC by insertion of section 115JH of the Act) w.e.f 1 April 2017 in respect of a foreign company which is considered as resident in India on account of POEM. Section 115JH of the Act, provides that the Central Government may provide for exception, modification and adaptation with respect to the provisions of the Act relating to computation of total income, treatment of unabsorbed depreciation, set off or carry forward and set off of losses, collection and recovery and special provisions relating to avoidance of tax to be applied in a

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case where a foreign company is said to be resident in India due to its POEM being in India for the first time (has never been resident in India before). Accordingly, a draft notification⁶⁵ inviting comments /suggestions thereon has been issued.

According to section 2(26) of the Act, 'Indian Company' means A company formed and registered under the Companies Act 1956⁶⁶ and includes;

- Company formed and registered under the former laws in force;
- A corporation established under the Central, State or Provincial Act.

Provided that the registered or principal office of the company is in India.

4.2.3. Person other than Individual and Company

According to section 6 of the Act, a Hindu Undivided Family, a firm, any other association of persons and any other person is said to be a resident in India in every case, except where the control and management of the affairs of such person is situated wholly outside India. Therefore, any association of persons or body of individuals shall be considered as resident in India under section 6 unless the whole of its affairs are controlled or managed outside India.

4.3 Analysis of Article 4 under the Model Conventions

A person qualifies for the benefits of the Tax Treaty if he is Resident of either of the two Contracting States or of both the Contracting States. Hence, Article 4 assumes substantial importance. Mumbai Tribunal in the case of Bay Lines (Mauritius)⁶⁷ denied the benefit of Article 8 of the India- Mauritius tax treaty as the effective management of the enterprise was not in one of the contracting states but situated in a third state.

Broadly, the structure of Article 4, as per the OECD MC⁶⁸, which forms the basis of our discussion in this connection, is as follows.

- Article 4(1) defines the term "resident of a Contracting State"
- Article 4(2) establishes the rules for resolving cases of dual residence in case of individuals
- Article 4(3) lays down rule for ascertaining residential status in case of non-individuals such as companies and other non-corporate bodies.

4.3.1 Paragraph 1 of Article 4

Firstly, Article 4(1) of the OECD MC, determining 'resident of a Contracting State' are analysed as under.

Article 4(1) of the OECD MC reads as follows:

⁶⁵ F No 370142/19/2017-TPL dated 15 June 2017

⁶⁶ Now the Companies Act, 2013

⁶⁷ ITA.no. 1181/Mum/2002

⁶⁸ OECD MC 2017

‘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, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, 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’

The aforesaid Paragraph establishes the criterion for taxation as a resident, for all persons covered by the Tax Treaty. For the purposes of the Tax Treaty, any person who is a resident of the Contracting States as per the laws of the respective contracting states shall be considered as a resident under the Tax Treaty.

In case of individuals, the definition aims at covering various forms of personal attachment as per the domestic laws of the Contracting States to establish fiscal domicile, for comprehensive taxation of the total income of the individual. In case of companies and other non-corporate entities, the criterion for taxation as a resident was the place of effective management of such entities. However, this position has changed with the revision to Article 4(3) of OECD MC 2017 which shifts the focus from Place of effective management being the conclusive test for the purpose of tie-breaker. Now, the determination of residency is to be done by the Competent Authorities by mutual agreement having regard to its place of effective management, place of incorporated / constitution and any other relevant factors.

It is pertinent to note that the UN MC⁶⁹ is worded slightly different and reads as follows –

*‘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 that person’s domicile, residence, **place of incorporation**, place of management or any other criterion of a similar nature, ...’*

As highlighted above, Paragraph 1 of the UN MC includes ‘place of incorporation’ as one of the criterion for determining fiscal residence of persons other than individuals.

In the light of the above, we can examine the provision of the Act. As stated earlier, as per section 6(1) of the Act, the duration of stay of any individual in India is considered to be criterion for determining fiscal domicile of an individual in India.

In case of a company, according to the provisions of the Act a company is said to be a resident in India, if it satisfies either of the parameters to determine fiscal domicile of a company i.e., place of incorporation or place of effective management.

Further, Paragraph 1 of Article 4 explicitly states that the Contracting States and the political sub-divisions or local authorities are ‘residents’ as per the Tax Treaty. This was not explicitly mentioned in the Tax Treaty prior to the year 1995. The OECD MC was subsequently amended to make a particular mention of the same.

⁶⁹ UN Model Commentary 2011

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In the later part of Paragraph 1, Article 4 clarifies that a person is not to be considered as 'resident of contracting state' according to Article 4 of the Tax Treaty, if he is subject to limited taxation as per the domestic laws of the Contracting States only due to income from sources in that State or capital situated therein, and not by reason of his domicile. It would be interesting to understand the context of this provision. In this regard, please note that the term *liable to tax* relates to a person and not to the income.

Under Article 4(1), a person is a resident of a contracting state if he is *liable to tax under the laws of that Contracting State* as per the criterion mentioned therein, i.e., domicile, residence, place of incorporation etc. The Tax Treaty in this regard, intends to cover only the persons subject to comprehensive tax on their total income and thereby specifically excludes any person, who is paying tax only on income from sources in the state. For example a non-resident is asked to pay tax in the Contracting State on income earned from sources in that state. Therefore, by operation of Article 4(1), such non-resident is not considered as resident of that contracting state under Article 4 of the tax treaty merely because he pays tax in that contracting state. In this background, Article 4(1) clarifies that liability to tax per se does not make a person resident if such liability is only with respect to income from sources in that State.

This clarificatory provision exists mostly for individuals such as foreign diplomatic and consular staff serving in the other Contracting State. This exclusion in Paragraph 1 of the Article also relates to conduit companies set-up to exploit the benefits arising out of the tax treaties. Therefore, within the meaning of Article 4 such conduit companies are not considered as Resident as per provisions of the Tax Treaty.

Further, Article 4 of the Tax Treaty also includes persons who are liable to comprehensive taxation in the Contracting States but are exempt from actual payment of tax due to operation of law. For example charitable and other organisations, who on fulfilling the requirements laid down in the domestic law, may be exempt from payment of tax. They are thus subject to tax laws of the Contracting States, though there is no actual payment of tax. The OECD Commentary in this regard states that, 'liable to tax' as stated in Paragraph 1 of Article 4, does not mean actual payment of tax and includes persons who are exempt from payment of tax due to operation of law of the Contracting States.

In some states such as the US, a list of such entities is provided.

For example, paragraph 2 of the US MC reads as follows –

'The term "resident of a Contracting State" includes:

- a. a pension fund established in that State; and*
- b. an organization that is established and maintained in that State exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that State'.*

Given the above, it is evident that according to the provisions of US MC unless the entities which

are exempt from tax are explicitly listed under the Article 4 of the Tax Treaty, they are not be considered as a resident of the Contracting State as per the Tax Treaty. Accordingly, such persons will be unable to avail the benefits of the Tax Treaty.

Article 4(1) of the India-USA Tax Treaty

Article 4(1) of the India-USA Tax Treaty, reads as follows –

‘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, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that

- a. *this term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and*
- b. *in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries’.*

Article 4(1) of the India-USA Tax Treaty is largely similar to the OECD MC. However the second clause to Article 4(1) is in place to determine taxation of partnerships, estates and trusts. According to the tax laws of USA, a partnership firms, estates and trusts are never taxed as such. Income of the partnership firms, estates and trusts are included in the hands of the partners or beneficiaries, as the case may be and it is they who are taxed in the US under their domestic tax law. Hence as per the second proviso to Article 4(1), fiscal domicile of the partners or beneficiaries coupled with a requirement that they are “subject to tax” in their hands determines the extent of Treaty benefit available to income earned by the aforesaid bodies.

Judicial Precedence

- The Supreme Court, in the case of Azadi Bachao Andolan, held that ‘liability for taxation’ is not to be determined on the basis of an exemption granted in respect of any particular source of income, but by taking into consideration the totality of the provisions of the income-tax law that prevails in either of the Contracting States. Merely because, at a given time, there may be an exemption from income-tax in respect of any particular head of income, it cannot be contended that the taxable entity is not liable to taxation in that Contracting State.

Liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of the Tax Treaty, what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. If this were not so, the Tax Treaty would not have used the words ‘liable to taxation’ but would have used some

appropriate words like 'pays tax'⁷⁰.

- The Apex Court of Finland held that, the term 'tax' should be interpreted in accordance with Article 2 of the Tax Treaty. Consequently, where a person is liable to taxes, but those taxes are not covered by Article 2, then such a person would not be 'liable to tax' for the purposes of Article 4 and accordingly the provision of the Tax Treaty does not apply⁷¹.

4.3.2 Paragraph 2 of Article 4

Paragraph 2 to Article 4 of OECD MC is reproduced in the UN MC. The same is examined below.

Paragraph 2 of Article 4 of OECD MC reads as follows –

'Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

- a. he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);*
- b. if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;*
- c. if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;*
- d. if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.'*

The aforesaid Paragraph relates to a case where, under provisions of Paragraph 1, an individual is a resident of both Contracting States. A series of tie-breaker rules are provided in Paragraph 2 to determine single state of residence for an individual. The first test is based on where the individual has a permanent home. Permanent home would mean a dwelling place available to him at all times continuously and not occasionally and includes place taken on rent for a prolonged period of time. Any place taken for a short duration of stay or for temporary purpose, maybe for reasons such as short business travel, or a short holiday etc. is not regarded as a permanent home.

If that test is inconclusive for the reason that the individual has permanent home available to him in both Contracting States, he will be considered a resident of the Contracting State where his personal and economic relations are closer, in other words, the place where lies his centre of vital interests. Thus, preference is given to family and social relations, occupation, place of business, place of administration of his properties, political, cultural and other activities of the

⁷⁰ UOI v Azadi Bachao Andolan (2003) 263 ITR 706 (SC)

⁷¹ IBFD Case No 2004: 116 (Supreme Administrative Court of Finland)

individual. Subparagraph (b) establishes a secondary criterion for two quite distinct and different situations:

- The case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;
- The case where the individual has a permanent home available to him in neither Contracting State.

In the aforesaid scenarios, preference is given to the Contracting State where the individual has a habitual abode⁷². In the first situation, the fact of having an habitual abode in one State but not in other appears therefore as the circumstance which, tips the balance towards the State where he stays more frequently. For this purpose, regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State. The second situation is of a case where the person does not have a permanent home in either of the States. For example, this could be a case of a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

Further, this rule does not specify over what length of time the comparison is to be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

Further, as per Paragraph 2(c) to Article 4, if the individual has habitual abode in both Contracting States or in neither of them, he shall be treated as a resident of the Contracting State of which he is a national. If the individual is a national of both or neither of the Contracting States, the matter is left to be considered by the competent authorities of the respective Contracting States.

Judicial Precedence

- The Mumbai Tribunal in the case of Shalini Seekond⁷³ held that the taxpayer is qualified as a resident of India based on the tie-breaker provisions of India-Sri Lanka tax treaty.
 - In order to determine if the taxpayer could be categorised as a resident of Sri Lanka, the following criteria laid down by the tax treaty were examined:
 - A person shall be deemed to be a resident of the state in which he/she has a permanent home available to him or her;
 - In case he/she has a permanent home available to him/her in both states, then he/she shall be deemed to be a resident of the state with which his/her personal and economic relations are closer (centre of vital interests).
 - As the taxpayer had been living in India after marrying an Indian national, her

⁷² Para 17 of OECD Commentary to Article 4 of OECD MC

⁷³ (2016)(180 TTJ 1)(Mum)

husband's home would be the permanent home available to her in India.

- Availability of a permanent home does not mean ownership of property or a home. It refers to a place of abode or dwelling which is available to the person at all times continuously as opposed to occasionally for the purpose of a stay necessarily of short duration such as travel for pleasure/education/business, etc.
- Even though the taxpayer does not own a home in India, her husband's home being available to her at all times, she was deemed to have a permanent home in India;
- As the taxpayer was living in India with her husband, it could not be said that her parents' home was her permanent home in Sri Lanka in the absence of evidence to prove that the taxpayer was, in fact, living in Sri Lanka permanently, regularly and consistently;
- Further, her personal and economic relations had moved to India upon her marrying an Indian national. Though she owned an immovable property in Sri Lanka, the sale of such property and reinvestment of its proceeds in India clearly reflected a strategic shift in vital economic interest from Sri Lanka to India.
- In the context of examining the test of "permanent home", the AAR has held that the expression 'permanent' does not denote 'everlasting or eternal'⁷⁴. It should be understood in an objective sense to be the opposite of 'for a limited period'. To illustrate, consider a national of State B, who is employed for an indefinite period in State A and resides continuously in State A taking up a house there, which may last for the duration of his employment in State A, which could be for several years. This makes it a 'permanent home'⁷⁵.
- The determination of centre of vital interests is mainly a question of fact⁷⁶.
- The Federal Court of Appeal of Canada, has held that the concept of 'habitual abode' involves notions of frequency, duration and regularity of stays of a quality which are more than transient and consequently, refers to a stay of some substance in a jurisdiction as a matter of habit i.e., the place where the individual normally or customarily lives⁷⁷.

4.3.3 Paragraph 3 of Article 4

Article 4(3) of the OECD MC reads as follows:

'Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having

⁷⁴ P No 24 of 1996, In re (1999) 237 ITR 798 (AAR)

⁷⁵Rajnikant R Bhatt v CIT (1996), 222 ITR 562 (AAR)

⁷⁶Rajnikant R Bhatt v CIT (1996), 222 ITR 562 (AAR)

⁷⁷Lingle v Her Majesty the Queen (2010) 12 ITLR 996

regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States'

Thus, it is important to note that to invoke Para 3 to Article 4 there must be a case of dual residency. The trite rule with respect to residential status of the assessee company comes into play when the assessee is resident of both the Contracting States. This concept has been upheld in the case of Martrade Gulf Logistics FZCo-UAE⁷⁸ where the Rajkot Bench of the Tribunal has rejected the application of tie breaker rule since the taxpayer was, in the facts of that case, not resident of both India and UAE.

Paragraph 3 of Article 4 of UN MC⁷⁹ reads as follows –

'Where by reason of the provisions of Paragraph 1 a person other than an individual is a resident of both the contracting states, then it shall be deemed to be a resident only of the state in which its place of effective management is situated'.

This paragraph concerns companies and other bodies of persons, other than individuals. The situation of dual residence may arise in case of companies and other non-corporate bodies in case where one Contracting State attaches importance to the place of incorporation and the other State to the place of effective management.

It would not be an adequate solution to attach importance to a purely formal criterion like registration. Under OECD-MC, when paragraph 3 was first drafted, it was considered that it would not be an adequate solution to attach importance to a purely formal criterion like registration and preference was given to a rule based on the place of effective management, which was intended to be based on the place where the company, etc. was actually managed. In 2017, however, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax avoidance cases involving dual resident companies. It therefore concluded that a better solution to the issue of dual residence of entities other than individuals was to deal with such situations on a case-by-case basis. As a result of these considerations, the current version of paragraph 3 (of OECD MC 2017) provides that the competent authorities of the Contracting States shall endeavour to resolve the cases of dual residence of a person other than an individual by mutual agreement.⁸⁰

In such cases the Competent Authorities of the respective Contracting States may decide upon the fiscal domicile of the companies and other non-corporate persons.

Paragraph 4 and 5 of the US MC are differently worded. Paragraph 4 of the US MC seeks to settle the dual residence of companies. According to Paragraph 4 of the US MC, if a company

⁷⁸ ITA 7 to9/Rajkott/2011

⁷⁹ UN Model Commentary 2011

⁸⁰ Para 22 to 24 of the revised OECD MC-2017, commentary to Article 4

is a resident of both the Contracting States due to provisions of the Paragraph 1 of Article 4, then the company shall be the resident of the Contracting State in which it was created or organised. In all other cases of dual residence, the Competent Authorities of the respective contracting states shall endeavour to decide upon the mode of application of the convention to the company.

Judicial Precedence

- In *Integrated Container Feeder Service vs JCIT*⁸¹, the Tribunal analysed whether a shipping company, incorporated in Mauritius and which carried on activity of operating ships in international traffic from India was eligible for the benefit under Article 8 (Shipping and Air Transport) India-Mauritius Tax Treaty, on the grounds that its 'place of effective management' was in Mauritius. The Tribunal held that its place of effective management was not in Mauritius on the following grounds –
 - No business activity was carried out in Mauritius
 - The owners were from a third state (UAE) and entire business correspondence was made at UAE. No business correspondence was made with Mauritius
 - Operating instructions were received from UAE
 - Place of effective management was in UAE, since all the staff, officers and captains were sitting in Dubai
- The Apex Court of Sweden, held that the 'place of effective management' refers to a place where all of the management functions are exercised⁸².
- In case of *Pearl Logistics and EX-IM Corporation*⁸³, the Rajkot Bench of the Tribunal in the context of Article 9 of the India-Denmark tax treaty held that income earned by the foreign company from operations of ships in international traffic is not taxable in India as POEM of such foreign company is outside India. The Tribunal observed that registration certificate, residence of shareholder and passport of owner show that the foreign company is a resident of Denmark. Director of the foreign company resides in Denmark and have been operating business wholly from Denmark. Further, all the important decisions are taken from Denmark in the form of meeting and therefore, the POEM and control is in Denmark.

Earlier, the emphasis of the courts was merely on the Place of effective management to determine the Residence of the taxpayer. However, by virtue of the recent amendment to the OECD MC in 2017 and the MLI signed by the jurisdictions pursuant to the BEPS initiative of the OECD, the residential status of such person shall be determined mutually by the competent authorities of these contracting jurisdictions having regard to the POEM, the place where it is

⁸¹ (2005) 278 ITR (AT) 182 (MUM)

⁸² IBFD Case No RA 2008 ref 30 (6639-06) (Supreme Administrative Court of Sweden)

⁸³ [2017 TII-57 ITAT Rajkot- INTL]-taxindiainternational.com

incorporated or constituted and other relevant factors. Article 4 further provides that in the absence of a mutual agreement between the competent authorities such person shall not be eligible to claim any relief or exemption from tax under the tax treaties, except as agreed by the competent authorities.

In ADIT (Intl Tax, Mum) v. Asia Today Ltd. [2021] 129 taxmann.com 35 (Mumbai - Trib.), it was held that re-domiciliation of the company by itself cannot lead to denial of treaty entitlements of the jurisdiction in which the company is re-domiciled, though, of course, the fact of re-domiciliation of the company could at best trigger detailed examination or the re-domiciled company being actually fiscally domiciled in that jurisdiction. In the present case, the assessee-company changed its domicile from British Virgin Islands to Mauritius and tax residency certificate was issued by RoC in Mauritius prior to completion of re-domiciliation process. The assessee-company was held to be entitled to treaty benefits of DTAA between India and Mauritius.

4.4 Conclusion

Article 4 of the Tax Treaty provides the definition of the term 'resident of a Contracting State'. This Article is imperative in determining the applicability or non-applicability of a Tax Treaty to a person. Article 4 also aims to address conflict of dual residence. It may be relevant to consider that from India's perspective while POEM may not remain the conclusive test for the purpose of tie-breaker, it is still one of the determinative factor in the mutual agreement procedure to determine residency. Also, with the advent of BEPS initiative, the signatories to the MLI would now resort to Mutual Agreement Procedure to resolve any disputes with respect to determination of residence in cases of dual residence.

5. Article 5 – Permanent Establishment

5.1 Introduction

The Concept of "Permanent Establishment" (PE) is defined in Article 5 of tax treaties. This expression is invariably used in all tax treaties. It has considerable importance as Article 7 mandates that existence of a PE in a jurisdiction is a pre-requisite for the purpose of taxation of business profit of an enterprise in that jurisdiction. In this Module, the jurisdiction or country of residence of the person is referred to as the Resident State (or State R) and the jurisdiction or country where the PE is located is referred to as the Source State (or State S).

The definition of PE is significant for Several Articles. The term "Fixed base in Article 14 (Independent Personal Services) can be understood by reference to the term "permanent establishment". Articles 10, 11 and 12 (dealing with dividends, interest, and royalties respectively) provide for reduced rates of tax at sources on payments of these items of income to a resident of the Resident state when income is **not** effectively connected to a PE in Source State. The concept of PE is also relevant in determining which contracting State may tax certain gain under Article 13 (Capital gains) and certain "other income" under Article 21.

5.2 Article 5 of the Model Conventions

The definition of PE in Article 5 does not use the qualifying words "unless the context otherwise requires". As such, the definition needs to be followed in all cases unless specifically excluded.

Briefly stated, Article 5 of the UN Model provides as follows:

- Article 5(1) contains the "basic rule" for PE. A PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on.
- Article 5(2) provides a list of Specific inclusions which are understood to prima facie create a PE e.g. an office, workshop, place of management
- Article 5(3) specifies the term PE in relation to building sites or construction or installation projects, etc.
- Article 5(4) excludes, by means of a list of exceptions, a number of fixed places of business from the PE concept.
- Article 5(5) stipulates that an enterprise's dependent agent constitutes a PE of the enterprise he represents, if he (agent) carries on certain specified activities.
- Article 5(6) contains a special rule for agents of insurance companies and is absent in the OECD Model.
- Article 5(7) provides that the business activities of an agent of independent status do not constitute a PE of the enterprise he (agent) represents, provided the agent satisfies certain prescribed conditions.
- Article 5(8) contains a rule for associated enterprises. The mere fact that one company controls another does not make the second company a PE of the first one.

In order to decide whether a PE is constituted, one has to undertake a functional and factual analysis of each of the activities undertaken by the establishment. Further, while deciding whether a PE exists or not, Article 5 has to be read as a whole".

PE under Indian Income Tax Act, 1961

While Article 5 defines PE in an exhaustive manner, section 92F(iia) of the Income-tax Act (in the context of Transfer Pricing Provisions) defines PE in an inclusive manner". The Supreme Court⁸⁴ has observed that the term PE in section 92F(iia) covers "service PE, agency PE, software PE, construction PE etc". While the expressions "service PE, agency PE and construction PE" are commonly used in international tax terminology, the expression "software PE" is not entirely clear as the same is not defined.

The comparable term to PE under the Indian tax law is "business connection" [s 9(1)(i)]. There exists a distinction between a "business connection" and a PE. Generally speaking, the concept of "business connection" is wider than PE and hence, a business connection may exist even without a PE, but the absence of a "business connection" may indicate absence of a PE. The

⁸⁴ DIT vs Morgan Stanley and Co. Inc.(2007) 292 ITR 416 (SC).

Finance Act 2018 further broadened the scope of the term business connection under the Act on the lines of proposed widening of definition of Permanent Establishment under Article 5 in tax treaties (as elaborated in Para 5.37 below).

Example

If a foreign investment manager functions from outside State S and does not get any assistance from State S, except by way of advice from various entities in State S, it does not have a PE in State S. However, if the business of such investment manager is so carried out that it necessitates an office in State S or the employment of personnel in State S or the carrying out of systematic operations in State S in some manner, then it may be necessary to consider, on facts, whether a PE exists in State S or not.

The expression "permanent establishment" has been used in relation to a "business of an enterprise" taxable under Article 7. It has not been used in relation to profits from operation of ship or aircraft in international traffic covered under Article 8.

The AAR⁸⁵ has held that a return of income has to be filed in India (State of Source) even if a non-resident contends that it does not have a PE in India and consequently, takes a position that it is not taxable for business profits earned in India (State of Source). This is based on the logic that the decision about the existence or otherwise of a PE needs to be to the satisfaction of the assessing authorities, as otherwise the authorities would never get an opportunity to examine the matter. However, there are subsequent rulings⁸⁶ which have held that there is no obligation to file a return of income when there is no tax liability in India even if such nil tax liability is due to tax treaty benefit. However, in a case of a PE determination it would be best to file a return as the very concept of a PE is now a dynamic concept.

The burden of proof is upon the Revenue to prove the existence of a PE and it cannot ask the taxpayer to prove that a PE did not exist. The revenue authorities may determine existence of a PE even at the stage of examining a taxpayer's request for a certificate under section 197. Verification of the requisites of a PE must not only be conducted from a formal standpoint, but also, and above all, from a substantial standpoint. In other words, it may have to be decided on actual facts whether a PE exists in State S.

Whether a PE exists or not under Article 5(1) has to be ascertained separately for each enterprise that is, each entity and existence of a PE of one entity in a multinational group is irrelevant while determining whether another entity in the group has a PE.

If the revenue authorities have consistently accepted in the earlier years that the liaison offices of the taxpayer in India were not a PE, they would not be justified in treating them as a PE in a subsequent year without bringing any material on record pointing out any change in facts.

⁸⁵ XYZ/ABC Equity Fund, In re (2001) 250 ITR 194 (AAR).

⁸⁶ Vanenburg Group B.V. (2007) 289 ITR 464 (AAR), Dow Agro Sciences Agricultural Products Ltd (2016) 380 ITR 668 (AAR)

5.3 Article 5(1) of the UN Model: Permanent Establishment

Article 5(1) of the UN Model reads as follows:

"For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partially carried on."

Article 5(1) states the "basic rule" for a PE and expresses the primary meaning of PE.

Paraphrasing Article 5(1), a PE exists if the following conditions are satisfied cumulatively:

- There is an "enterprise".
- Such enterprise is carrying on a "business";
- There is a "place of business";
- Such place of business is at the disposal of the enterprise;
- The place of business is "fixed" and
- The business of the enterprise is carried on wholly or partially through this fixed place of business.

A PE does not exist unless all the aforesaid conditions are satisfied. To illustrate, if a foreign doctor (other than those covered by Article 14) provides services over a long period of time in Source State, but at different locations that do not meet some of the aforesaid conditions (eg, the doctor does not have power of disposal of the place of business), the doctor cannot be said to have a PE in State S.

Unlike the definition of "permanent establishment" in section 92F(iiiia) of the Income-tax Act, the definition of PE in Article 5(1) is exhaustive".

The definition cannot be considered in abstract and the functional test is to be applied to determine whether the taxpayer had a PE, that is, permanent infrastructure including office equipment, supervisory staff, and other features of such PE. In case tax authorities contend that there is a PE, they have to support their findings by adequate evidence.

In a generic sense, the term "permanent establishment" has been described: (a) as a virtual projection of the foreign enterprise in State S; or, (b) as a firm foot in the soil of State S; and (c) as not including casual transactions not involving the presence of the foreign enterprise for a considerable period of time in State S.

5.4 Business

Article 5(1) requires that the enterprise should be carrying on a "business". The UN Convention does not provide a definition of "business". Hence, by virtue of Article 3(2), in India the term would be construed in accordance with s 2(13) of the Income-tax Act which defines "business" as "including any trade, commerce or manufacture or any adventure or concern in the nature of

trade, commerce or manufacture". As held by some Courts⁸⁷ an activity carried on continuously in an organized manner with a view to earn profit is "business": The expression "affairs" may be much wider than the expression "business".

The question whether an activity constitutes a business or not is a mixed question of law and fact, which has to be decided on totality of all facts and circumstances of the case. In the context of whether a foreign institutional investor (FII)/venture capital fund (VCF) holds shares as a "capital asset" (which would involve capital gains under Article 13) or "stock in trade" (which involves a "business" and consequently falls within the purview of Article 5 and 7), the AAR⁸⁸ initially held that, inter alia, the following tests may be relevant:

- Powers in the Memorandum of Association.
- Extent to which transactions are substantial in nature (eg: shares are purchased with substantial borrowings, quantum of total holdings, etc).
- Largeness of systematic activity.
- Frequency of transactions (eg: multiplicity of transactions).
- Entries in books of accounts.
- Magnitude of purchases and sales.
- Ratio between purchases and sales.
- Period of holding.
- Motive behind the transaction (For instance, if the motive is to derive profit from purchase and sale of shares, the profit is a "business profit"; however, where the motive is to derive dividend etc, then any profit on sale of shares would be a "capital gain").

Subsequently, Courts⁸⁹ held as follows:

- For the purpose of classification of income, the terminology or the context used in the SEBI Regulations can be used to determine the nature of the transaction.
- The intention of the investors is an important factor in determining the question.
- Reference is invited to decision of the Supreme Court⁹⁰ in CIT v Holck Larsen, wherein it was highlighted that the real question is not whether the transaction of buying and selling the shares lacks the element of trading, but whether the latter stages of the whole operation show that the first step of the purchase of the shares was not taken as, or in

⁸⁷ Clifford Chance Vs DCIT (2002) 82 ITD 106 (Mum) ; Western Union Financial Services Inc Vs ADIT (2006) 101 TTJ 56 (Del), ; Booz & Company (Australia) (P.) Ltd., (2014) 42 taxmann.com 288 (AAR).

⁸⁸ P No 10 of 1996, In re (1997) 224 ITR 473 (AAR) ; XYZ/ABC Equity Fund, In re (2001) 250 ITR 194 (AAR); AAR No 566 of 2002, In re (2004) 271 ITR 1 (AAR)

[see also Morgan Stanley and Co International Ltd (2005) 272 ITR 416 (AAR)].

⁸⁹ Fidelity North Star Fund, In re (2007) 288 ITR 641 (AAR), Acee Enterprises [2015] 54 taxmann.com 74 (Del HC).
⁹⁰ (1986) 160 ITR 67 (SC).

the course of, a trading transaction.

- In order to ascertain whether the first step of the purchase of the shares was not taken as, or in the course of, a trading transaction one has to take cognizance of the legal framework and circumstances prevailing at the time of making the investment and the facts of the case.
- The circumstances and the framework of the plethora of legislative provisions unmistakably point out that an FII is not registered for carrying on trade in securities; it can only invest in securities for the purpose of earning income by way of dividends/interest and realising capital gains on the transfer.
- In light of the above, it will be preposterous to impute that FIIs, who responded to the offer of investment in securities following the regulatory guidelines, registered under the SEBI Regulations and undertook to abide by those regulations, would, in the very first step itself, have intended to violate all the legislative requirements which provided them the opportunity to enter the capital market in India.
- Accordingly, the transaction is only in the nature of investment in capital assets to earn "capital gains".

The following factors may not be relevant:

- The nature of receipt arising from the activity (e.g. royalty, technical services, dividend or interest).
- The fact that the taxpayer has not entered contracts of a similar nature with others.

The aforesaid tests have to be applied in totality and not in isolation. For instance, mere authority in the memorandum of association is not conclusive of the nature of transaction; there must be some material to show that in furtherance of the objects clause in the memorandum, steps are taken or it is given effect to. Again, frequency of transactions, though an important factor, is not decisive. It is well settled that a single plunge may amount to a business venture if surrounding circumstances so indicate.

It is possible for a taxpayer to have two portfolios of securities, that is, an investment portfolio consisting of capital assets and a trading portfolio comprising of stock-in-trade (trading assets). With a view to reduce litigation and to maintain consistency in approach during assessments, the Central Board of Direct Taxes (CBDT) has issued Circulars⁹¹ providing guidelines for determination of the character of a particular investment i.e. whether the same is in the nature of a capital asset or stock-in-trade, and on taxability of income arising from transfer of listed and unlisted shares.

⁹¹Instruction No. 1827, dated August 31, 1989, Circular No. 4 /2007 dated 15 June 2007, Circular No.6/2016 dated 29 February 2016, InstructionF.no.225/12/2016 dated 2 May 2016

5.4.1 Illustrations of "business"

The following are certain examples of a "business":

- A VCF formed with the object of carrying on business of acquiring or investing in securities of all kinds, and ultimately selling at a profit, and carrying on the activity by acquiring large block of securities in companies pursuant to an intricate and complex system of investments, carries on a "business";
- A foreign enterprise carrying on the business of rendering money transfer services across international borders appointed agents in India for paying the monies to the beneficiaries after satisfying themselves about their identity and verifying the genuineness of the claim. The agreement of agency was initially for a period of five years which could be renewed for successive periods of one year. The agents could appoint sub-agents and had to maintain records and measure up to the standards set by the foreign principal. They received training from the foreign principal in the use of the software and communication systems. All these activities carried on systematically and continuously with a set purpose, amounted to a "business".

5.4.2 Project office

There is divergence of judicial thinking on whether a "project office" formed with the permission of the Reserve Bank of India (RBI) constitutes a PE under Article 5(1).

5.4.3 Supply of labour

The AAR⁹² has held that an enterprise carries on a "business" when it engages skilled labour to supply them to other companies requiring such labour, gets paid on the basis of certain rates per unit of labour employed and, consequently by effecting economies in the scale of wages it offers to its employees, earns a margin of profit for itself. However, contrary views have also been expressed by other judicial authorities.

5.4.4 Profession

Merely because a person happens to be professionally qualified, it cannot be said that such a person's activity cannot be treated as carrying on of "business". It is important to see how it is carried on. A professional activity can also be characterised as an activity of carrying on "business" if it is carried on like a commercial activity". Thus, where a medical practitioner does not confine himself to his conventional function of examining patients and prescribing medicines but establishes an X-ray machine for augmenting his professional work, it cannot be said that he has no profit motive in such adventure and that he is not carrying on a "business" activity.

5.5 "Place of business" test

This test requires that in order to constitute a PE, the foreign enterprise should have a "place of business". The term "place of business" is not defined. A "place", though normally a particular

⁹² Tekniskil (Sendirian) Berhard Vs CIT (1996) 222 ITR 551 (AAR)

portion of space", must be read in light of it being used to define an "establishment". A "place of business" means all the tangible assets (e.g., premises, facilities, machinery or equipment, or installations) used for carrying on the business, whether or not they are exclusively used for business purpose. In marginal cases, one tangible asset may be sufficient. The nature of the fixed place of business is very much that of a physical location, that is, one must be able to point to a physical location through which the business is carried on. The term "place" is wide enough to cover a large geographical area. Hence even a hawker paddling his wares on a particular street can be said to have his place of business on that street.

5.5.1 Illustrations: Place of business

- An office of 10 ft by 10 ft.
- A depot for storing imported goods.
- A fully equipped diving support/fishing vessel
- A computer server.
- A place of business which is notified under s 592 of the Indian Companies Act, 1956.
- A facility for berthing at a port in Source State which is guaranteed for foreign ships provided on a time charter.
- Residential premises, if used for carrying out business activities.
- A motor racing circuit⁹³.
- Lockable space for storing tools and equipment within a stadium and lighting facilities⁹⁴.
- Vessels engaged in seismic surveys on the high seas in connection with the exploration of mineral oil/ natural resources⁹⁵.

5.5.2 Illustrations: No "place of business"

- Intangibles (e.g., an internet website) – as opposed to a server.
- No services are rendered in India by an international newspaper (X) when it receives advertisement charges from its Indian client (Y) for publishing Y's advertisements in X's newspapers"

5.6 "Power of disposition" test

The place of business should be at the disposal of the foreign enterprise for the purposes of its business activities. Some right or domain or control to use a place is required for having a PE. Such place of business may be owned or rented or may also be situated in business facility of another entity, if the enterprise has a power of disposition. However, such power need not be a

⁹³Formula One World Championship Ltd (2017) 394 ITR 80 (SC)

⁹⁴ Production Resource Group (2018) 401 ITR 256 (AAR)

⁹⁵ SeaBird Exploration FZ LLC (2018) TS-162-AAR-2018 (AAR)

legal right to use a place and an illegally occupied place could also constitute a PE if the enterprise has some domain or control to use it (See example of hawker above). At the same time, no PE exists merely because an enterprise is present at a particular place if that place is not at the disposal of the enterprise, or that the presence is very limited. There should be some evidence to indicate that whenever any employee of the foreign enterprise came to State Source, he could straightaway walk into the business premises and occupy a space or a table. The onus is upon the Revenue to prove this.

5.6.1 Illustrations

- Mere possession of a mailing address in Source State without an office, telephone listing or bank account does not result in a PE.
- Occasional use of business premises of a group company (allowed gratis) in Source State to negotiate contracts does not create a PE.
- A salesman who visits his customer's office in Source State to collect orders does not have the office at his disposal merely on account of his visits and hence, his employer does not have a PE. However, there could be a PE if the foreign enterprise has an office at his disposal together with telephone and telex, where its employees work.
- An oil rig is not at the disposal of a contractor who provides personnel for manning, operation and management of an oil rig.
- Where a parent provides management services to its subsidiary through its (parent's) personnel sitting in its (parent's) premises, such premises are not at the disposal of the subsidiary.
- A website hosted on the computer server of an internet service provider does not result in the server being at the disposal of the enterprise (say "W") owning the website, even if W can choose the particular server on which its website should be hosted. If, however, W leases and operates the server on which its website is hosted, such server is at its disposal,

5.6.2 Purpose of use of premises

Use of the premises should create an impression in the minds of the business customers of the foreign enterprise in Source State, that the office of the group company can be viewed as a projection of foreign enterprise's activities in State S.

5.7 Place of business must be "fixed"

5.7.1 Definition of "fixed"

The concept of "fixed" has two aspects: that of space (location test) as well as that of time (permanence test).

5.7.2 "Location" Test

(a) Specific situs

The "location test" requires the place of business to be located at a "single place". Such place could be:

- a specific place or a distinct place within Source State (that is, it should have a specific situs); or
- moving within a specific geographical point or area or location".

In case a foreign enterprise does not operate in Source State at a distinct place, then it does not constitute a PE, even if it operates for a long duration in the State.

(b) Specific place

The place of business should be a specific place within State Source. It is not necessary that the equipment constituting the place of business has to be affixed to the ground; it is enough that the equipment remains on a particular site. The possibility of it being moved is irrelevant; what is important is whether it is in fact moved.

(c) Existence of "geographical" and "commercial" coherence

The expression "fixed place" does not necessitate that the place of business should be stationary and not moving. It involves identifying a "definite place" as the place from which a business is carried on. It is necessary that "there should be both "geographical" and "commercial" coherence". Thus, an area cannot be regarded as a single place of business, if: (i) the activities are carried on within a limited geographical area but there is no commercial coherence": or, (ii) it constitutes a coherent commercial whole but lacks geographical coherence"

5.7.3 "Permanence" Test

(a) Meaning of "permanence"

The use of the word "permanent" itself suggests that a PE can exist only if the place of business has a certain degree of permanency. The activity need not be "permanent" in the sense of everlasting eternal in nature or without interruptions. Permanence of the place has to be gauged only for as much time as the business requires. Hence when the race was to be conducted only for three days in a year and for the entire period of race, the place was at the disposal of the assessee, the permanence test was met⁹⁶.

At the same time, the expression "fixed" contains, in itself, the indication of a reasonable period for the existence of the place of business and in order to constitute a PE, the presence in Source State must be more than merely temporary or transitory.

For instance, an overseas supplier, who merely sells equipment to an Indian buyer and sends

⁹⁶Formula One World Championship Ltd (2017) 394 ITR 80 (SC)

⁹⁶ SeaBird Exploration FZ LLC (2018) TS-162-AAR-2018 (AAR)

its expert engineer to India to supervise erection of the equipment for a short period, does not have a fixed place of business since it did not establish any establishment in India of a permanent or enduring nature either wholly or substantially which would amount to a virtual projection of the supplier in India.

(b) Intended permanence/actual conduct

The term "fixed" and the condition of "permanence" implicit therein should be construed by intent as well as conduct.

(c) Duration

Article 5(1) does not make reference to any minimum period for which a PE should be in existence in Source State. Article 5(3) suggests that the duration of a "basic rule PE" under Article 5(1) need not be for years but may be for a few months as well. PE may emerge even if place of business exists for a short period of time in certain circumstances e.g. in case of recurrent activities. However, an isolated activity cannot result in a fixed PE as the ingredients of regularity, continuity and repetitiveness are essentially missing. The term "fixed place" and test of permanence is purely contextual and thus "relative" in light of the facts of the case. The Courts have been sensitive to this issue of permanence and have consistently held in recent times that the nature of business shall determine the permanence or fixed place in relation to a business carried on in India.

(d) Calculation of time threshold

(i) Commencement of A PE comes into existence as soon as a foreign enterprise begins to carry on its business through a fixed place of business. For this purpose:

- The business is regarded to have commenced once the foreign enterprise is "prepared" at the place of business for its activities in the State.
- The period of time during which the place of business is being set up in Source State should not be considered, if this activity is substantially different from the activity which is intended to be carried on from the place of business in Source State.

(ii) Cessation of PE

A PE ceases to exist when the business is no longer "carried on through a fixed place of business or the fixed place is disposed off

5.8 "Business activity"/"Business connection" tests

The business of a foreign enterprise must be carried on ("business activity test") wholly or partially through a fixed place of business ("business connection test"). It may be carried on in Source State:

- pursuant to the physical presence of the entrepreneur himself, or his personnel (eg, employees, dependent agents", etc)⁹⁷; or
- through automatic equipment (eg, vending machines, computer, etc) when the foreign

⁹⁷DIT Vs Morgan Stanley and Co. Inc. (2007) 292 ITR 416 (SC).

enterprise operates and maintains such equipment'. Human intervention may not be necessary for existence of a PE⁹⁸.

5.8.1 "Through which"

The word "through" has a wide meaning. It includes: (a) a situation where business activities are carried on "in" a fixed place of business; or (b) a place where business is not literally carried on "in" a place (eg, a road construction site). The word "through" is used to be consistent with the language of Article 7(1) which refers to a foreign enterprise carrying on a business and making profits through a PE in State of Source.

The fact that a foreign entity (A) derives economic benefit on account of activities of another entity (B) at a place of business in Source State, does not mean that A carries on its business "through" that location. To illustrate, if A procures management services from B, it (A) does not have a PE if B is carrying on its business in State of Source by using its own personnel. An exception could be a case where the management services and the relations between A and B are such that A can be construed to be carrying on its own business through the medium of such services rendered by B.

5.8.2 Agent

In certain situations, the business of a foreign principal may be carried on by its agent in State of Source. Having regard to this, if the agent works at a fixed place of business and carries on the business of the foreign enterprise in State of Source, a PE could be constituted under Article 5(1) although no "agency" PE is constituted under Article 5(5).

5.8.3 Business "carried on"

The expression "carries" denotes "actual carrying on" of business and does not cover a "would have carried on" situation.

5.9 Article 5(2) of the UN Model

Article 5(2) of the UN Model reads as follows:

"The term 'permanent establishment' includes especially:

- (a) A place of management;
- (b) A branch;
- (c) An office;
- (d) A factory;
- (e) A workshop;
- (f) A mine,
- (g) An oil or gas well, a quarry or any other place of extraction of natural resources."

⁹⁸P No 24 of 1996, In re (1999) 237 ITR 798 (AAR).

Article 5(2) is inclusive and it contains an illustrative list of places which, *prima facie*, constitute a PE. The common thread in all these examples is that an enterprise can carry on business in State of Source through these establishments. What is not included in Article 5(2) is not automatically excluded from Article 5(1), as is discussed below:

- (i) A warehouse, (ii) a farm, and (iii) a store or other sales outlet, constitutes a PE even though not specifically provided for in Article 5(2).
- A "simple depot" or "depot agency" or "inspection or repair depots" ", owned and operated by a container leasing enterprise (CLE), could be regarded as a PE although, no PE may exist if such depots are owned and operated by independent enterprises.

5.9.1 Article 5(2) in relation to Article 5(1)/5(4)

There are divergent views on the relationship between Article 5(2) and 5(1). As per one view⁹⁹, a place of business enumerated in Article 5(2) constitutes a PE only if it satisfies the tests of Article 5(1) i.e. paras 1 and 2 of Article 5 complement each other. Thus, a project office, although specifically illustrated under Article 5(2)(c), does not result in a PE if it does not satisfy the "business activity" test under Article 5(1). However, as per the other view, Article 5(2) is independent of Article 5(1). This view is based on the well-established principle of statutory interpretation that an inclusive definition in Article 5(2) intends to add to the primary meaning in Article 5(1) so as to bring within its scope, items which may or may not fall within the scope of the primary definition. The Supreme Court¹⁰⁰ observed that Article 5(1) defines a PE in an exhaustive manner and it is for this reason that Article 5(2) illustrates to places included as PE of the foreign enterprise.

5.10 Components of PE under Article 5(2)

5.10.1 Place of management

The expression "management" in Article 5(2)(a) refers to the management of the foreign enterprise itself, and not of another entity and hence, a foreign entity/ enterprise does not have a PE under Article 5(2)(a) when it second an employee to its subsidiary in State of Source in order to manage the subsidiary.

A "place of management" could be situated in residential premises or even a hotel room. The term has to be interpreted widely.

5.10.2 Branch

A "branch" is "a division; a sub-division; department; a component portion of an organisation. It is a projection of an entity and depicts management and control of the entity over it. By itself, on account of its ("branch") meaning and statutory definitions, one associate company of a group of companies cannot be regarded as a "branch" of another company. Branch is the simplest example of a PE, and most foreign banks operate in India using the branch model.

⁹⁹National Petroleum Construction Company v DIT (2016) 383 ITR 648 (Del HC)

¹⁰⁰ DIT Vs Morgan Stanley and Co. Inc. (2007) 292 ITR 416 (SC).

5.10.3 Office

An "office" is mentioned, as such, for correspondence purposes. Unless defined otherwise in the domestic law, the term "office" would include a "place of management.

"Office" means a room, a set of rooms or building where the business of a commercial or industrial organisation or a professional person is conducted-. Thus, the term would include all types of offices including

- A "management office" performing supervisory and co-ordinating functions.
- Depending upon the facts, a project office" or liaison office or even a recruitment office of a labour contractor for recruiting labourers"; could also constitute an "office".

5.10.4 Factory

A factory would obviously be a permanent establishment of the foreign enterprise in the State of source.

5.10.5 Workshop

A contractor does not have a "workshop" on an oil rig when it merely provides personnel for manning, operation management of such rig.

5.10.6 Oil or gas well

This clause covers only those foreign enterprises which own or operate an oil or gas well in State Source.

5.10.7 Any other place of extraction of natural resources

Article 5(2)(f) refers to "extraction" and not "exploitation" or "exploration". The words "any other place" are without any limitation and hence, include onshore as well as offshore places. "Natural Resources" has been defined in Black's Law Dictionary-" as "any material from nature having potential economic value or providing for substance of life, such as, timber, minerals, oil, water and wildlife". However, in the context of Article 5(2)(f), it can include only those natural resources which are capable of "extraction". Thus, the term includes hydrocarbons or minerals embedded in the Article.

The foreign enterprise should be engaged in extraction of natural resources. Mere provision of personnel for assisting in extraction is excluded from Article 5(2)(f).

5.10.8 Installation for extraction or exploitation of natural resources

Article 5(2)(j) of the India-US Tax Treaty provides that an installation or structure used for the exploration or exploitation of natural resources could result in a PE if used for a period of more than 120 days in any 12 month period. The India-Australia Tax Treaty provides that the term PE includes" an installation or structure, or plant or equipment, used for the exploration for or exploitation of natural resources". The installation or structure should be owned or operated and hence this clause does not cover a contractor engaged in the business of burial of pipelines, which does not own or operate such installation or Structure. The provision does not cover all

installations but only those used for exploration or exploitation of natural resources.

5.10.9 Warehouse

Certain Indian treaties include "a warehouse" in Article 5(2).

5.10.10 Sales outlet

Article 5(2)(h) of the India-Netherlands Tax Treaty/Article 5(2)(f) of the India-UK Tax Treaty includes "a premises used as a sales outlet" in the definition of PE. The provision does not cover a place used for effecting delivery of courier packages. A "sales outlet" receives or solicits orders.

By itself, an associate company of a group of companies cannot be regarded as a "sales outlet".

Article 5(2) of the OECD Model is identical to Article 5(2) of the UN Model.

5.11 Article 5(3) of the UN Model

Article 5(3) of the UN Model reads as follows:

"The term 'permanent establishment' also encompasses

- (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
- (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period."

Paraphrasing sub-paragraph (a), a PE exists if the following conditions are satisfied:

- There is a building site, a construction, assembly or installation project or supervisory activities in connection therewith; and
- Such site, project or activities last more than six months.

Paraphrasing sub-paragraph (b), a PE exists if the following conditions are satisfied:

- Services, including consulting services, are furnished by an enterprise;
- Services are furnished through employees or other personnel engaged by the enterprise for such purpose;
- Activities of that nature continue (for the same or a connected project) within State of Source; and
- Such activities continue for a period or periods aggregating more than six months within any 12-month period.

There is no PE if the prescribed time limits are not exceeded and hence, a construction, installation or assembly project in State of Source cannot be treated as a PE unless it continues

for a period of more than six months, although it might otherwise fulfill the definition under Article 5(1).

If the prescribed time threshold is exceeded, the site or project constitutes a PE from the first day of the activity. There is no standard deduction of the period prior to the crossing of the threshold time limit.

Article 5(3) is not subject to Article 5(1); for example, the foreign enterprise need not have the power of disposition (control and domain) over the place where activities specified in Article 5(3) are performed.

5.11.1 Building site, a construction, assembly or installation project

The words "building site, a construction, assembly or installation project or supervisory activities" have to be read in their plain meaning. The exact nature of activities of the foreign enterprise is a matter of fact and evidence.

5.11.2 Project

The expressions "site" and "project" are not synonyms. The word "project" has been defined as "a large or major undertaking, especially one involving considerable money, personnel and equipment". A "project" may be carried on at more than one "site" or "location" and the fact that the work force is not present in State Source for more than six months in one particular "site" or "location" is immaterial; the activities performed at each "spot" or "site" are part of a single "project" and such "project" must be regarded as a PE if, as a whole, it lasts for more than six months in State Source.

5.11.3 Article 5(3) in relation to Article 5(2): Office, workshop, place of management, etc

If a building site or a project does not last for more than six months, then it does not constitute a PE, and if there exists within it an office or other places that are illustrated under Article 5(2), such places also do not constitute a PE.

At the same time, where an office or workshop is used for a number of construction projects, then, even if none of these projects continues for more than six months, it (office/workshop) will be considered as a PE under Article 5(2) if it satisfies the conditions of Article 5. Likewise, in case of a foreign enterprise engaged in construction activity, its office used for storage, advertising activities, answering telephone calls and maintaining books of accounts, could constitute a PE even if no specific construction site constitutes a PE and the place of management continues to remain in State of Residence.

5.11.4 "Threshold time limit" applies to each individual site or project"

The "six month test" applies to each site or project except where such sites or projects form a coherent whole commercially and geographically¹⁰¹. Hence, time spent on unconnected sites or projects is to be ignored. Specific language of the tax treaty under consideration needs to be

¹⁰¹Sumitomo Corpn. [2008] 114 ITD 61 (Delhi ITAT)

examined.

5.11.5 Commercial and geographic coherence

A series of contracts by a contractor that are interdependent both commercially and geographically are to be treated as a single unit for the purpose of applying the threshold test of "six months". Thus, a building site based on several contracts should be regarded as a "single unit" if it forms a "coherent whole" commercially and geographically. To illustrate, the construction of a housing colony is a "single unit" even if each house is constructed for different customers".

5.11.6 Abuse of "threshold time limit"

Domestic anti-avoidance legislative or judicial rules may be applied to prevent schemes to artificially avoid the six months threshold.

5.11.7 Determination of "six month threshold"

(a) Tenure

Tenure of a contract can be ascertained from the contract, invoice etc. in determining the date of commencement or completion, independent confirmation/certificate by the contractor, terms of contract, audited financial statements, correspondence with contractor, no-objection certificate granted by income-tax department to facilitate remittance, date of closure of project office etc. may be relevant. The onus is upon the Revenue to prove that the "time threshold" in Article 5(3)(a) is exceeded.

(b) Month

The AAR¹⁰² observed, without detailed analysis that "six months" means a period of "183 days".

(c) Commencement of PE

According to one view, a site in State of Source exists from the date on which a contractor begins his preparatory work eg, when he begins a planning office, etc. However, according to the other view, the "six month threshold" commences from the date the work physically begins in the State

(d) Cessation of PE

A PE continues as long as the site, project or supervisory activities continue and it ceases to exist when: (a) the work at a site or of a project or the supervisory activity is completed or permanently abandoned; or, (b) the foreign enterprise ends its business activities in State of Source for good. A PE for a dredging contract ceases only when the dredger is completely demobilised; it does not cease from the date of completion of the dredging activity or on closure of "project office". Seasonal or temporary interruptions of operations (eg, on account of bad weather, lack of raw materials or labour problems) cannot be regarded as a closure and such period should be included in determining the life of a site, although the concept of "temporary" may often be vague.

¹⁰² P No 24 of 1996, In re (1999) 237 ITR 798 (AAR).

(e) Time spent by sub-contractor

The expression "permanent establishment" in Article 5(3)(a) is defined with reference to an enterprise in relation to a site or project or supervisory activities. Hence, if a foreign enterprise (main contractor) sub-contracts part of its work in State Source in relation to such site or project or activities to a sub-contractor, the time spent by the sub-contractor must be considered as time spent by the main enterprise in State S; further, if a sub-contractor is on a site intermittently, time is measured from the first day the sub-contractor is on the site until the last day (that is, intervening days when the sub-contractor is not on the site, are counted).

5.11.8 Agents

The Andhra Pradesh High Court¹¹ held that when the Convention has made special provision in Article 5(5) in respect of agents, it is highly doubtful that Article 5(3) intends to once again cover the case of an agent so as to render the conditions imposed in Article 5(5) otiose.

5.12 Article 5(3) of the OECD Model

Article 5(3) of the OECD Model reads as follows: "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months." Article 5(3) of the OECD Model differs from Article 5(3)(a) of the UN Model as follows:

- the OECD Model excludes assembly and supervisory activities; and
- it increases the threshold from six months to twelve months. This is with a view to narrowing the scope of the source rule in such cases.

The UN Model incorporates sub-paragraph (b) with a view to allow State of Source to tax management and consultancy services provided therein.

5.12.1 Services

Article 5(3)(b) of the UN Model applies only to "services" and hence, it does not apply to other type of activities that do not constitute "services" such as manufacturing.

5.12.2 Services in State of Source

Article 5(3)(b) applies only if services are performed by a foreign enterprise within State Source, Hence, where a foreign enterprise provide telecommunication services to its customers located in State of Source through a satellite located outside State of Source, such services are outside the purview of Article 5(3)(b), It is also a question whether such services can be said to have been rendered through employees or other personnel. 'Other personnel' can be understood as persons who work as per the instructions of the foreign enterprise (e.g. dependent agents). Services cannot be said to have been rendered in State of Source merely because invoice has been furnished in State of Source or payment has been made in State S.

5.12.3 Article 5(3)(b) applies to a "service provider"

On a plain reading, it appears that Article 5(3)(b) applies if a foreign enterprise ("service

provider") furnishes services in State S. However, the AAR¹⁰³ has held that an overseas parent company ("service availer") has a PE in India if its Indian subsidiary provides services to it (parent) for use outside India.

5.12.4 Hiring of labour/secondments/ global mobility arrangements

In DIT v Morgan Stanley and Co Inc, an Indian company "MSAS" provided BPO services (on a cost plus basis) to "M", its US group company. M's staff was also sent on deputation on request of MSAS to work under MSAS' direction and control. The staff continued to be on M's payroll and MSAS was to reimburse the compensation cost of M without profit element. Performance appraisal, promotion, discipline etc was to be carried out in consultation with M. M also sent its staff to India for stewardship and other similar activities to ensure high standards of quality by MSAS [which provided BPO services (on a cost plus basis) to M] and to protect business interests of its (M's) shareholders. The Supreme Court¹⁰⁴ applied Article 5(2)(l) of the India-US Tax Treaty [equivalent to Article 5(3)(b) of the UN Model] in relation to the presence of the deputationists. The SC laid down the twin conditions for establishing a Service PE under Article 5(2)(1) of the India-US Tax Treaty i.e.

- where the activities of the foreign enterprise entail it being responsible for the work of the deputed personnel, and
- the employees continue to be on the payroll of the foreign enterprise or they continue to have their lien on their jobs with the foreign enterprise.

The Supreme Court was of the view that an employee of M, when deputed to MSAS, did not become an employee of MSAS. He had a lien on his employment with M and as long as the lien remained with M, the said company retained control over the deputationist's terms and employment. It observed that M deputed its staff on a request from MSAS depending upon its (M's) requirement and on completion of his tenure, the depute was to be repatriated to his parent job. He lent his experience to MSAS as an employee of M since he retained his lien and in that sense there is a service PE under Article 5(2)(1) of the India-US Tax Treaty.

Further, in a later ruling in Centrica India Offshore (P) Ltd¹⁰⁵, it was observed that there was no clear obligation on the Indian entity to bear the cost of the seconded employees and further that such employees continued to enjoy entitlement to their overseas social security and retirement benefits. The creation of a Service PE was thus upheld on the basis that though the Indian entity may have had operational control over the secondees, these limited and sparse factors cannot displace the larger and established context of employment abroad.

However, in the Morgan Stanley case (supra), the Supreme Court did accept M's contention that it did not have a Service PE on account of its stewardship activities in India. It observed as

¹⁰³ P No 8 of 1995, In re (1997) 223 ITR 416 (AAR).

¹⁰⁴ DIT Vs Morgan Stanley and Co Inc (2007) 292 ITR 416 (SC)

¹⁰⁵(2014)(227 Taxman 368)(SC)

follows:

- A customer is entitled to insist on quality control and confidentiality from the service provider.
- Stewardship activities involve briefing of MSAS' staff to ensure that the output meets the requirements of M and include monitoring of the outsourcing operations of MSAS.
- The stewards were not involved in the day-to-day management of MSAS or in any specific services to be undertaken by MSAS and that M was not providing any services to MSAS.
- The stewardship activity was basically to protect the interest of the customer (M) by ensuring quality and confidentiality of services and in such circumstances, stewardship activities would not fall under Article 5(2)(1) of the India-US Tax Treaty.

Based thereon, a similar view was expressed by the Delhi High Court in *DIT v E-Funds IT Solution*¹⁰⁶. However, in *Centrica India Offshore (P) Ltd* (supra), the Court observed that the outsourced back office support functions in the case before it, cannot be characterized as mere stewardship activities. The observations of the Delhi High Court in case of *E-Funds IT Solution* were subsequently upheld by the Supreme Court in case of *E Funds Corporation and E Funds International*¹⁰⁷.

Further, in an interesting decision in the case of *ABB FZ LLC*¹⁰⁸, the Bengaluru ITAT held that furnishing of consultancy services by the assessee through its employees pursuant to a regional headquarter service agreement, fell within the ambit of service PE under Article 5(2)(i) of the India – UAE DTAA. The ITAT rejected the assessee's stand that since the employees remained in India for 25 days only, service PE was not triggered. It observed that in the present age of technology where services, information, consultancy, etc., can be provided through various virtual modes like email, internet, video conference, etc., services can be rendered without the physical presence of employees of the assessee. It thus held that it is not the stay of the employees for more than 9 months which is required to be there, but what is required is the rendering of services or activities for more than 9 months within 12 months period.

5.12.5 Same or a connected project

The words "same or a connected project", do not cover unrelated projects

5.12.6 Determination of "time threshold"

The period of six months referred to in Article 5(3)(b) applies in relation to furnishing of services by an enterprise and hence, applies to the enterprise and not to the employees or other personnel. Thus, the same employees need not be present in State of Source throughout the specified period. To the extent the foreign enterprise is performing its services in State Source on a particular day through at least one employee, that day would be considered while

¹⁰⁶(2014) 364 ITR 256 (Del HC)

¹⁰⁷ ADIT vs E Funds IT Solution [2017] 399 ITR 34 (SC)

¹⁰⁸ (2017) 83 taxmann.com 86 (Bng ITAT)

determining the period of presence in State of Source.

5.13 Article 5(4) of the UN Model

Article 5(4) of the UN Model reads as follows:

"Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:

- (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
- (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
- (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- (f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."

Model Commentaries state that the purpose of Article 5(4) is to prevent a foreign enterprise from being taxed in State of Source, if it carries on activities of a purely preparatory or auxiliary character in State of Source; such activities in State Source may be productive, but are so remote from the actual realisation of profits that it is difficult to allocate any profit to State of Source, or that it is only possible to attribute insubstantial profits to State S.

5.13.1 Co-relation with Article 5(1)

Article 5(4) lists a number of business activities which are exceptions to the general definition laid down in Article 5(1); such exceptions are absolute notwithstanding that a particular activity otherwise satisfies the tests of a PE under Article 5(1).

5.13.2 Article 5(5) in relation to 5(4)

Article 5(4) starts with the words "Notwithstanding the preceding provisions of this Article" and consequently, overrides only Article 5(1) to Article 5(3). However, in view of the specific exclusion in Article 5(5)(a), Article 5(5)(a) is subject to Article 5(4).

5.13.3 Activities only "for the enterprise"

Article 5(4) uses the expressions "belonging to the enterprise" or "for the enterprise". Hence, a fixed place of business mentioned in Article 5(4) does not constitute a PE only if its activities in State of Source are performed "on behalf of" or for the enterprise to which it belongs. However, a PE exists if such activities are also carried on behalf of other enterprises or if the activities are

aimed at directly benefitting a third party as well.

5.13.4 Only exempted activities should be carried on

Having regard to the use of the word "solely" in Article 5(4), a fixed place of business mentioned in Article 5(4) does not constitute a PE if its activities in State of Source are only restricted to activities specified therein. However, if a fixed place of business is used for "exception activities" (e.g. for storage or display of goods or merchandise) and also for other activities (e.g. sales), it would not be eligible for the exemption and would be regarded as a "single PE" taxable in respect of both types of activities.

5.13.5 Disposal of movable property

Once a fixed place of business is deemed not to be a PE under Article 5(4), then the profits arising out of such activity as stated in Article 5(4) is also exempt. Thus, profit on the disposal of the stock-in-trade on termination of the enterprise's preparatory or auxiliary activity in State of Source is also covered by the exception in Article 5(4) and, profits on the sale of products displayed in a fair or exhibition in State of Source and sold at the termination of the fair, are not taxable in State of Source.

5.14 Article 5(4)(a) of the UN Model

Article 5(4)(a) applies to the use of facilities by an enterprise for storage or display of goods or merchandise belonging to it.

5.14.1 Exclusion of "delivery"

Unlike the OECD Model, Article 5(4)(a) of the UN Model does not include "delivery" and restricts para (a) to "storage or display". The word "delivery" is deleted in the UN Model since stocking of goods in State of Source for ensuring quick delivery to the customers facilitates sales of the products and thereby earning of profit in State S. Consequently, a warehouse in State of Source used for delivery of goods would be a PE.

5.15 Article 5(4)(b) of the UN Model

Article 5(4)(b) relates to the stock of goods or merchandise and provides that such stock shall not be treated as a PE if it is maintained solely for the purpose of storage or display for the enterprise.

5.16 Article 5(4)(c) of the UN Model

Article 5(4)(c) provides that a PE is not constituted when a stock of goods or merchandise belonging to a foreign enterprise is maintained solely for processing by another enterprise in State of Source.

5.17 Article 5(4)(d) of the UN Model

Article 5(4)(d) is wide enough to cover all enterprises including an enterprise in the form of a

newspaper bureau.

5.18 Article 5(4)(e) of the UN Model

Article 5(4)(e) provides a generalised exception to the definition of PE in Article 5(1).

5.18.1 "Preparatory or Auxiliary"

The terms "preparatory" and "auxiliary" have not been defined in the Convention. It is often difficult to distinguish between the activities which are "preparatory or auxiliary" in character and those which are not. The facts of each case have to be individually examined to ascertain whether the activities have a "preparatory" or "auxiliary" character. "Preparatory" is generally "something that prepares or serves to prepare for the core activity." "Auxiliary" generally connotes "ancillary" or "subsidiary". An "auxiliary" activity involves helping, assisting or supporting the main activity-. Having regard to this, a fixed place of business does not exercise a "preparatory or auxiliary" activity when the activity of the fixed place of business in State of Source forms an essential, indispensable and significant part (as opposed to only a small part) of the activity of the whole enterprise, this being the decisive criterion.

5.19 E-Commerce

The OECD Commentary discusses the applicability of Article 5(4)(e) in various e-commerce situations. OECD's project on Base Erosion and Profit Shifting (BEPS) also discusses the taxation of E commerce in the context of BEPS by multinational enterprises in detail. It emphasis on the potential tax base erosion by the phenomenally growing digital economy, where the sole basis of taxation ought to be on the basis of situs of economic value addition or consumption of such value by customer base. Accordingly, substantive amendments have been suggested in domestic tax laws of states for taxing digital economy transactions. In this context, pursuant to the BEPS Action Plans, as detailed in Para 5.37 below, India has amended the definition of business connection to provide that if a foreign enterprise has significant economic presence in India (as specifically defined under the Act), such foreign enterprise shall be deemed to have business connection in India, leading to tax consequences in India.¹⁰⁹

5.19.1 Project Office

There is a view that a project office set up by a non-resident in India primarily as a support office for the purpose of facilitating the performance of a contract, falls within the purview of Article 5(4)(e). However, the ITAT has, without any discussion, found a project office to be outside the purview of Article 5(4)(e). Further, in another ruling¹¹⁰, the AAR held that a project office only used as a communication channel and not for execution of contracts by an assessee engaged in fabrication and installation of petroleum platforms, would qualify as an auxiliary activity not constituting a PE. The determination thus depends on the overall facts of each case.

¹⁰⁹ Explanation 2A to clause (i) of sub-section (1) of section 9 by the Finance Act, 2018,

¹¹⁰National Petroleum Construction Company v DIT (2016) 383 ITR 648 (AAR) (Delhi-HC)

5.19.2 Liaison office

There is a divergence of views regarding liaison offices constituting a PE :

- In UAE Exchange Centre LLC, the AAR¹¹¹ held that an Indian liaison office of a foreign enterprise engaged in remittance services, performs an essential activity and thus, falls outside Article 5(4)(e) when such liaison office downloads information (such as names and addresses of beneficiaries, amount to be remitted, etc.), prints cheques/ draft and dispatches them to the addresses of beneficiaries through courier. In certain other cases¹¹² it was held that the liaison/ representative office was not a PE. Where no violation was reported by the RBI, the activities of the liaison office were presumed of preparatory and auxiliary character¹¹³.

Identifying new customers, marketing activities, price negotiation, discussion of commercial issues, securing and processing orders have led to the liaison office forming a PE¹¹⁴. Courts have observed that merely because the Head Office received orders and payments directly from the buyers and also sent goods to them directly, would not mean that only liaison work was done by the liaison office. However, receiving information, enquiries and feedback for passing it on to the Head Office and co-ordination activities have been held as preparatory in nature. Recently, Court has held that a liaison office of the assessee-group in India which carried out core marketing and sales activities and had prominent involvement in the contract finalization process, showed that the overseas entities of the group carried on business in India through such fixed place of business and thus had fixed place PE in India. It also noted that the India office was not only for data collection and information dissemination rather it discharged of vital responsibilities relating to finalization of commercial terms etc.¹¹⁵

- In the OECD Commentary, Czech Republic and Slovak Republic have observed that a commercial representation office, that is involved in commercial negotiations for import of products in State of Source, does not carry on auxiliary or preparatory activities, if essential parts of the contracts (eg quality, quantity, time frame and terms of delivery) are determined by such office.
- In the case of GE Energy Parts Inc¹¹⁶, the Delhi Tribunal held that as the activities carried out were substantial and core, the liaison office of one of the group entity was a fixed place PE of the assessee as well as of other overseas entities in the group for which such activities were carried out.
- The Delhi High Court held in Mitsui & Co. Ltd¹¹⁷.that where the revenue had been unable

¹¹¹ (2004) 268 ITR 9 AAR.

¹¹²Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP HC), Motorola Inc. (2005) 95 ITD 269 (Del ITAT)SB)

¹¹³Metal One Corpn (2012) 52 SOT 304 (Del ITAT)

¹¹⁴Jebon Corporation India v CIT (2012) 206 Taxman 7 (Kar HC), Brown And Sharpe Inc v CIT (2014) 369 ITR 704 (All HC),

¹¹⁵ GE Energy Parts Inc. vs CIT (Intl Tax) [2019] 101 taxmann.com 142 (Del HC)

¹¹⁶(2017) 184 TTJ 570 (Del ITAT)

¹¹⁷ (2017) 84 taxmann.com 3 (Del HC)

to show that the liaison office of the assessee was used for the purpose of business or trading activity, the Tribunal was correct in holding that the assessee did not have a PE in India and was therefore exempt under the provisions of the DTAA between India and Japan. It observed that it was not enough for the revenue to show that the assessee had an office, factory or a workshop etc. within the meaning of Article 5(2) of DTAA; For the purpose of Article 5(1), the revenue was required to show that such place was a fixed place of business through which the business of an enterprise is wholly or partly carried out.

The fact whether a liaison office constitutes a PE will thus have to be examined based on facts and circumstances of each case and it cannot be presumed that a liaison office will always be excluded from the purview of Article 5.

5.19.3 Advertising activity

There is no PE in State of Source when a fixed place of business engages solely in promotional advertising for the goods manufactured by the foreign enterprise.

Indian treaties

Article 5(3)(e) of the India-US Tax Treaty specifically excludes from PE, the maintenance of a fixed place of business solely for the purpose of advertising for the enterprise.

5.19.4 "For the enterprise"

In terms of Article 5(4)(e), a fixed place of business in State of Source has to be maintained "for the enterprise" and hence, if it renders services not only to its enterprise but also to other enterprises, it does not fall within the exception to Article 5(4).

5.20 Article 5(4)(f) of the UN Model

Article 5(4)(f) provides that where a fixed place of business combines any of the activities mentioned in sub-paragraphs (a) to (e) then, as long as the combined effect of the overall activity of such fixed place of business is preparatory or auxiliary, a PE should not be deemed to exist

Article 5(4)(f) should not be interpreted rigidly and ought to be considered in light of the facts and circumstances. However, enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each part is merely engaged in a preparatory or auxiliary activity.

5.21 Articles 5(5) and 5(7) of the UN Model: Agency PE

Articles 5(5) and 5(7) deal with the concept of "dependent agent PE" which is wholly hypothetical and fictional.

Article 5(5) of the UN Model reads as follows:

"Notwithstanding the provisions of paragraphs 1 and 2, where a person-other than an agent of an independent status to whom paragraph 7 applies-is acting in a Contracting State on behalf

of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

- (a) has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or
- (b) has no such authority, but habitually maintains in the first mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise."

Article 5(7) of the UN Model reads as follows:

"An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph."

Paraphrasing, Article 5(5) and 5(7), a PE is constituted for another person if the following conditions are satisfied:

- there is a person;
- he is acting on behalf of an enterprise;
- he is acting in State of Source;
- he is not an independent agent to whom Article 5(7) applies, and
- the conditions in either sub-paragraph (a) or (b) of Article 5(5) are satisfied
- activities are not limited to those mentioned in Article 5(4)

That is: the person has an authority to conclude contracts in the name of the enterprise; such authority is habitually exercised; and the person's activities are not limited to those mentioned in Article 5(4) [Article 5(5)(a)] or there is no authority as specified in Article 5(5)(a); the person habitually maintains in State of Source a stock of "goods or merchandise; and from such stock, the agent regularly delivers goods or merchandise on behalf of the principal [Article 5(5)(b)].

5.22 Independent agent

Paraphrasing Article 5(7), a person will not constitute a PE of another person ("principal") if:

- such person is a broker, general commission agent or any other agent ("agent");
- he acts in the ordinary course of his business;
- he is independent of his principal.
- his activities are such which could not be considered as devoted exclusively or almost exclusively on behalf of his principal; and
- conditions made or imposed between him and the principal in their commercial and financial relationship do not differ from those which would have been otherwise made between independent enterprises.

An agent of independent status needs to be independent both legally and economically. Refer detailed discussion in Para 5.33 in this regard.

5.23 Article 5(5) of the UN Model: Introduction

Article 5(5) refers to what is popularly known as "Agency PE". It contains a deemed inclusion clause" and commences with a non-obstante clause overriding Article 5(1)/(2). Accordingly, a foreign enterprise may be treated as having an Agency PE in State of Source even though it may not satisfy all the tests in Article 5(1) (such as not having a fixed place of business at its disposal in State of Source within the meaning of Article 5(1) and 5(2), or not satisfying the time threshold of six or twelve months).

5.24 Articles 5(5) and 5(7) of the UN Model

Articles 5(5) and 5(7) must be read together. On such combined reading, the following two principles emerge:

- Article 5(5) applies only to a case where the person, who acts on behalf of a non-resident, is not an agent of independent status within the meaning of Article 5(7).
- Even when an agent fails to come up to the standard of independence mentioned in Article 5(7), the issue regarding PE is not closed but has to be resolved in terms of Article 5(5). In other words, a dependent agent does not automatically constitute a PE for its principal unless it (agent) satisfies the requirements of Article 5(5)(a) or (b).

5.25 Article 5(5) and 5(1)

If a dependent agent works at the fixed place of business of its non-resident principal in State of Source, a PE of the principal may exist under Article 5(1) and (2), even if the agent is not authorised to conclude contracts. In other words, if the principal has a PE within the meaning of Article 5(1) and (2), it is not necessary to show that the agent would fall under Article 5(5).

5.26 Whether a website can be treated as an Agency PE

It is necessary that a "person" is acting in State of Source on behalf of a foreign enterprise. The

term "person" is defined in Article 3(1)(a) as including an individual, a company and any other body of persons. A website is not a "person" and thus, cannot constitute an Agency PE.

5.27 Agency relationship

It is necessary that the agent should act "on behalf of" a foreign enterprise in State of Source. Section 182 of the Indian Contract Act defines "agent" as a person employed to do any act for another or to represent another in dealing with third parties. An "agent" is one who works for another in accordance with his authority while dealings with third parties or who canvasses for his principal. He may be a person who is, responsible for, or can act or enforce anything on behalf of, his principal. His activities accrue to the benefit of the principal and are interconnected with his principal's business. An "agent-principal" relationship presupposes an identity of interest or character or personality and unity in profit making, A principal has some control over its agent's activities and can interfere with performance of agency function.

An "agent" is different from a contractor or "sub-contractor". In order to determine the existence of a "principal-agency" relationship one has to look into the substance or essence of the agreement rather than its form.

5.28 Dependent agent

Article 5(5) refers to "a person" without any qualification. As such, a dependent agent could be:

- any entity, including individuals or companies : or
- employees of the foreign enterprise, or non-employees;
- residents of State of Source or non-residents.

What is defined as a "dependent agent PE" is not the dependent agent, per se, but it is by virtue of a foreign enterprise having a "dependent agent" that the enterprise is deemed to have a PE. It is the brokers, agents, etc who constitute "Agency PE" and not their employees. It may have to be decided on facts as to whether persons employed to carry on a principal's activities are independent. Substance over form approach must be used to determine this, and nomenclature in agreement and other documents may not be sufficient, if there is evidence to the contrary available. For instance, there could be a case of blank agreements signed by the foreign enterprise available with the agent, who then would fill up the same while entering into a contract. As such, though prima facie the agreement is entered into by the foreign enterprise, in fact the same was executed by the agent, leading to existence of DAPE.

In the GE Energy Parts Inc ruling¹¹⁸ (supra), the Delhi Tribunal further held that GE India (comprising expatriates deputed to India and the employees of the Indian entity) constituted a dependent agency PE of the assessee and the other entities in the group, as it had authority to conclude contracts on their behalf. The Tribunal also observed that though the number of GE overseas entities managed by GE India was more than one, all the entities were in the

¹¹⁸(2017) 184 TTJ 570 (Del ITAT)

businesses of the GE group and GE India was not an agent of independent status working for other third parties in India.

5.29 Satisfaction of Article 5(5)(a) or (b) of the UN Model

Mere dependency of an agent is not sufficient to constitute an Agency PE. Having regard to the use of the word "if" in Article 5(5), an Agency PE would be constituted by only those dependent agents who satisfy the conditions of Article 5(5)(a) or (b). In eBay International AG, the Mumbai Tribunal¹¹⁹ has held that though the Indian group companies answered the description of a dependent agent, a dependent agency PE in terms of Article 5(5) of the India – Switzerland tax treaty was not formed as the agents did not perform any of the activities mentioned under Article 5(5).

5.30 Article 5(5)(a) of the UN Model

If the conditions mentioned in Article 5(5)(a) are satisfied, then, a PE exists for all the purposes for which an agent acts for its foreign principal and not only to the extent it (agent) exercises its authority to conclude contracts in the name of the foreign enterprise.

Further, Article 5(5) refers to a person acting on behalf of "an enterprise" and provides that "that enterprise shall be deemed to have a permanent establishment". The use of the words "an" and "that" would imply that the existence of a PE under Article 5(5)(a) has to be determined separately for each group company independently, and existence of a DAPE for one of the group companies would not mean that the entire group of the foreign enterprise has a PE in the source country.

5.30.1 Authority to conclude contracts

Only persons having and exercising an "authority to conclude contracts in name of the enterprise" can lead to a PE for the foreign enterprises". The principles in connection with the determination of authority to conclude contracts, are explained below:

- A person can be said to have such authority if: he has sufficient authority to bind the enterprise in State of Source and to decide the final terms of the contract. i.e. whether he can act independently, on his own, freely, and without control from the principal, is he authorised to negotiate all elements and details of a contract which are binding on the enterprise.
- It is not necessary that an agent should enter into contracts "literally" in the name of the enterprise; as long as he has an authority to conclude contracts which are binding on the enterprise, the case is covered within Article 5(5) even if those contracts are not actually in the name of the enterprise.
- It is the "actual authority" which is relevant. To illustrate: an agent may be considered to possess such actual authority when he solicits and receives orders but does not formally

¹¹⁹(2013) 140 ITD 20 (Mum ITAT)

finalise them, the principal routinely approves them and the orders are sent directly to a warehouse from where goods are delivered by the principal.

- The term "has" refers to the legal existence of an authority to conclude contracts', it is not necessary that the agent should have been formally given a power of representation. Lack of active involvement by a principal may indicate that the agent has an authority to conclude contracts on behalf of its principals.
- On the other hand, there is no authority to conclude contracts when: an agent signs contracts only after obtaining approval from its principal or based on standard terms determined by its principal, an agent is performing his duty. The words "duty" and "authority" do not connote the same relationship, in as much as what is considered to be a "duty" cannot be considered to be an "authority". A "duty" connotes an obligation which a person is bound to perform. By making a payment in State S on behalf of his principal, the agent is only performing his duty for which he is remunerated and is not exercising any authority.

Illustrations: Lack of authority to conclude contracts

- An internet service provider who merely provides a server on which a foreign enterprise hosts its website, does not have an authority to conclude contracts in the name of the foreign enterprise.
- Mere service of duplicate copies of the orders on an agent does not make the agent as a person who has powers to conclude contracts.
- An investment adviser obtaining information and passing it to the investment manager is not concluding contracts,
- A BPO (back office unit) in India does not have an authority to conclude contracts when it renders support services to foreign clients on account of reconciliation, research, etc.

5.30.2 Habitual exercise of authority to conclude contracts

(a) Habitually

An agent must habitually exercise an authority to conclude contracts. The expression "habitually" refers to a systematic course of conduct on the part of the agent and would mean "repeatedly" and "not in isolated cases. The extent and frequency of activity necessary to determine whether the agent is habitually exercising his authority, cannot be laid down precisely and will depend upon the nature of the contracts and business of the principal.

(b) Exercise

In order to trigger Article 5(5), mere existence of the authority to conclude contracts is not sufficient; it is essential that the authority is actually "exercised" by the dependent agent in State of Source. He should, through actual conduct, utilise such power. This fact is to be determined on the basis of the commercial realities of the situation and for this purpose substance prevails over form, and no straight jacket rule can be laid down.

The expression "exercise" denotes "application of a right" or "exertion of influence or power". An agent, who negotiates all elements of a contract on behalf of its principal is binding the principal, and hence acts not for himself but for the principal to this extent.

However, mere participating in negotiations by an agent on behalf of its principal without binding the principal does not amount to "exercise" by the agent of an authority to conclude contracts in the name of the principal.

5.30.3 Article 5(5)(a) is subject to Article 5(4)

Article 5(5)(a) has to be read in light of Article 5(4); hence, activities of a dependent agent (including employees) which are restricted to such purposes as mentioned in Article 5(4) do not create a PE for the principal.

5.31 Article 5(5)(b) of the UN Model

Article 5(5)(b) is absent in the OECD Model. Article 5(5) of the UN Model, which is substantially broader in scope than Article 5(5) of the OECD Model, limits the scope for tax evasion. The onus is upon the Revenue to prove that Article 5(5)(b) is attracted especially when the taxpayer produces evidence that the local agent does not maintain any stock of goods on behalf of the foreign principal.

On a plain reading, it appears that the expression "has no such authority" indicates the absence of authority of the nature mentioned in Article 5(5)(a).

5.31.1 Physical Stock: Whether necessary?

On a plain reading, Article 5(5)(b) applies only if the dependent agent physically maintains a stock of goods or merchandise in State of Source. The AAR¹²⁰ has held that it is not necessary to maintain a physical stock and that a line access to inventory may be sufficient. Thus, an agent in State of Source may be regarded as maintaining stock of goods on behalf of a foreign enterprise, if the agent has password protected access to the website of the foreign enterprise to access (and download) its (foreign enterprise's) standardised business information reports.

5.31.2 Sales related activities

The expression "from which he regularly delivers goods or merchandise on behalf of the enterprise" denotes a delegation of sales function, rather than a sale.

One could say that no PE exists if all sales-related activities and maintenance of stock of goods take place outside State of Source, and mere delivery by an agent takes place in State of Source; however, a PE exists, if the sales-related activities (eg, advertising or promotion) are also conducted in State of Source on behalf of the principal and have contributed to the sale of such goods in State S.

¹²⁰ Dun & Bradstreet Espana S A , In re (2005) 272 ITR 99 (AAR) ;AAR No 656 and 657 of 2005, In re (2206) 284 ITR 1 (AAR).

5.31.3 Article 5(4)(c) of the India-US Tax Treaty

Article 5(4)(c) of the India-US Tax Treaty considers a dependent agent to constitute a PE of his principal if "he habitually secures orders in the first-mentioned state, wholly or almost wholly for the enterprise". As per the Protocol to the India US Tax Treaty, Article 5(4)(c) is attracted, if the following conditions are satisfied:

- the agent frequently accepts orders for goods or merchandise on behalf of his principal;
- substantially all of the agent's sales related activities in State of Source consist of activities for his principal;
- the agent habitually represents to persons offering to buy goods or merchandise that acceptance of order by the agent constitutes the agreement of the principal to supply goods or merchandise under the terms or conditions specified in the order; and
- the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.

5.32 Article 5(7) of the UN Model

Article 5(7) contains a deemed exclusion clause. The test in Article 5(7) is objective. Model Commentaries state that it has been inserted for the sake of clarity and emphasis, although logically an independent agent cannot constitute a PE of the foreign enterprise.

5.33 Independent Agent

An agent will not constitute a PE of its principal if, inter alia, he is "an agent of independent status" that is, "independent" of the enterprise. The expression "independent" means "not subject to the authority or control of any person; free to act as one pleases, autonomous. Such independence has to be comprehensive that is, legal, functional and also economic and financial. This, inter alia, depends on the extent of the obligations of the agent in relation to its principal. Generally speaking, the requirements of "independence" may be met where:

- the agent operates from a position of strength, knowledge or skill in relation to the foreign enterprise; or,
- he has overall control over an autonomous business conducted by him, bears the risk of his business, and receives reward through the use of his skills and knowledge.

In Morgan Stanley & Co Inc, M, a US company, along with other foreign group companies, availed of support services from MSAS, an Indian group company. The AAR¹²¹ held that the functions and the activities of MSAS are wholly and exclusively dependent on the applicant both legally and economically as is evident from the fact that for the year 2003-04, the entire revenue was received from Morgan Stanley Group only; there was no revenue from any independent

¹²¹ Morgan Stanley & Co Inc (2006) 284 ITR 260 (AAR)- The Supreme Court [(2007) 292 ITR 416 (SC)] did not expressly comment on this aspect of the AAR Ruling

party.

The onus is on the principal to show that a particular agent is of an independent status. Determination of independence is a factual exercise and all facts and circumstances must be taken into account. For this purpose,

- (i) the exact working of the agent;
- (ii) the correspondence between the agent and the principal;
- (iii) the mode of functioning of operations;
- (iv) the quantum of work done;
- (v) the services rendered;
- (vi) the contracts undertaken for outsiders (that is, other than the principal and the companies controlled by it) would have to be examined to determine whether the agent is of an independent status or not;

However,

- (i) the fact that the agent is a subsidiary; or
- (ii) the mode of receipt of commission (e.g. whether in Indian currency or foreign currency) would not make any difference in ascertaining independence

5.33.1 Legal independence

(a) Relevant factors

The factors relevant in determining legal independence of an agent are summarised below:

- Whether the agent's commercial activities for his principal are subject to detailed instructions or comprehensive control by the principal; or the extent to which the agent exercises freedom in the conduct of his business on behalf of the principal (an independent agent is generally not subject to significant control with respect to the manner in which he carries out his work).
- Whether an agent's scope of authority is affected by limitations on the scale of business which may be conducted by it (agent) (eg, an agent whose principal has contractually imposed a condition of exclusivity may not be independent depending on the overall facts).
- Whether an agent represents multiple principals? (An agent who represents multiple principals may be legally independent. However, even where he acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by him (agent), legal dependence may yet exist if the principals act in concert to control the acts of the agent.
- Whether the principal is relying on the special skill and knowledge of the agent (such reliance would mean independence).

-

(b) Irrelevant factors

The factors which may not be relevant in determining legal independence of an agent are summarised below:

- Limitations on the scale of business which may be conducted by the agent.
- Extent to which the agent exercises freedom within the scope of the authority conferred by the agency agreements.
- The control that a parent company exercises over its subsidiary in its capacity as a shareholder (This principle is expressly recognised in Article 5(8) of the UN Model).
- Existence of checks and balances within an international group of companies to ensure that group companies work as a well knit group, catering to the needs of the others, each being entitled to use the international group brand names.
- All disabilities and disqualifications in the agency agreement are fastened to the agent alone.

5.33.2 Economic independence

While determining whether the agent is "economically independent", the following factors are relevant:

- Extent to which the agent bears "entrepreneurial risk" or "business risk". "Business risk" primarily refers to the risk of loss. An agent that shares "business risk" with its principal, or has its own "business risk", is "economically independent" because its activities are not integrated with those of the principal.
- Whether the agent acts exclusively or nearly exclusively for the principal. While it is not determinative, an agent is less likely to be independent if its activities are performed wholly or almost wholly on behalf of only one principal over a long period of time. An agent who represents multiple principals may be economically independent. An exclusive relationship may indicate that the principal has economic control over the agent. However, an agent, although exclusive, who has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits, is not economically dependent.

Agency devoted "wholly or almost wholly" on behalf of one principal

The "activities" referred to in Article 5(7) are that of the broker, general commission agent or any other agent and not of the foreign enterprise.

The word "wholly" means entirely, completely, fully, totally. The expression "almost wholly" means almost entirely, very near to wholly, a little less than whole; in terms of percentage, it

means anything more than 90%¹²². Thus, an agent does not carry out activities "wholly or almost wholly" for its principal when its (agent's) activities for the foreign enterprise yield say, 75% to 80% of its (agent's) income and income from other principals is, say between 20% and 25%.

What is relevant is that the agent's activities are for a single principal and not that the principal's activities are carried on by a sole agent¹²³. Hence, the mere fact that the entire work of the foreign enterprise in State of Source is done through a sole agent does not result in a "dependent agency relationships". A contrary view was expressed earlier in DHL Operation B.V¹²⁴.

In deciding whether or not the activities of an agent are confined to one principal:

- the correspondence between the agent and principal has to be examined;
- the mode of their functioning and operations, has to be examined in totality.
- existing facts and not prospective facts have to be examined
- the fact that the agency agreement prohibits the agent from accepting any agency of a competitor without first obtaining the principal's consent, is not relevant.

Judicial opinion is divided on whether "other activities" of the agent should be considered in determining a PE.

5.34 Ordinary course of business

An agent will not constitute a PE of the principal only if, inter alia, he is acting in the "ordinary course" of his business. A broad view has to be taken in these matters. The expression "ordinary course of their business" has been interpreted as follows:

- The word "ordinary" means "normal".
- The expression "in the ordinary course of business" is also used in s 32(2) of the Indian Evidence Act in which it has been held to mean "the current routine of business usually followed by a person" or "in which he was ordinarily or habitually engaged"; the business itself may be of a temporary character".
- The OECD Commentary provides that "ordinary course" of business of an agent refers to the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent; other business activities carried out by such agents are to be ignored; in certain cases (eg, where the agent's activities do not relate to a common trade), other complementary tests may be used.

Reference needs to be made to normal custom/ trade i.e. activities that are customary for brokers, general commission agent or other agents operating in the same line of activity as the enterprise's agent, to perform. For this evaluation one may need to go by a customary practice

¹²² AAR in Speciality Magazine (274 ITR 310)

¹²³Rolls Royce Singapore (P) Ltd (2011) 202 Taxman 45 (Del HC), B4U International Holdings Ltd (2015) 374 ITR 453 (Bom HC)_

¹²⁴(2005) 142 Taxman 1 (Mum ITAT)

applicable in a given industry as compared to what may be applicable in respect of a given agency relationship

- An agent carrying on his own business is acting in the "ordinary course" of his business. For this determination, the theoretical powers or the legal amplitude of the activities permissible under the agent's Memorandum of Association are not relevant
- An agent is acting in the "ordinary course" of his business, if his activities are incidental to his main business, or if his activities are an integral part of his business.

In view of the above, an agent cannot be acting in "ordinary course" of his own business if he performs activities which economically belong to the sphere of the foreign enterprise rather than to that of his own business operations. Where the agent and principal are affiliated, the relevant comparison may be made in respect of the business activities carried out within the group as well as industry practice or normal custom of the trade in which the agent is engaged.

In this context it is worth noting some of the significant amendments to the concept of Agency PE by the 2017 update of the OECD Model Convention and its commentary, wherein the following aspects are relevant from Indian perspective.

In the context of the dependent agent PE (DAPE), the 2017 update expands the scope of DAPE to cover a person who habitually plays the principal role in the conclusion of contracts that are routinely concluded without material modification by the enterprise. India has reserved a right on non-inclusion of the term "routinely." In other words, Agency PE can be created even if contracts are concluded without material modification by the enterprise on a non-routine basis.

The 2017 Commentary further provides that if a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is "closely related", such person shall not be considered to be an independent agent. India has reserved a right on non-inclusion of the term "to which it is closely related." Therefore, according to India, if a person acts exclusively or almost exclusively on behalf of one or more enterprises, such person may not qualify as an independent agent, irrespective of whether such person is closely related to the enterprise or not.

Moreover, in the context of low risk distributor of goods, the 2017 Commentary suggests that a buy-sell distributor (irrespective of whether it is an associated enterprise or not) may not be regarded as a DAPE since it is neither acting on behalf of a non-resident enterprise nor is it selling goods that are owned by such enterprise. The goods that are sold to the customers are owned by the distributor itself. This conclusion would apply even if the distributor acted as a "low-risk distributor." India does not agree with the above interpretation because it considers that distribution of goods owned by an associated or related foreign enterprise may create PE of such foreign enterprise, particularly in a case where the risks are not borne by such distributor of goods.

Examples:

- A newspaper publishing company, whose principal business is publication of newspapers in State of Source and which also carries on business of collection of advertisements for

foreign newspapers, acts in the "ordinary course" of its business when it enters into solicitation agreement (for procuring advertisements) with foreign principals.

- The Department of Posts accepts money orders for transfer of funds within India. Engaging itself in the same type of business with international ramifications, that is, money transfer services across international borders, is just an extension of its business and hence, is in the ordinary course of its business.
- An entity, that produces television software (say X) and which licenses its software to a broadcasting entity (say Y), acts in the ordinary course of its business" when it (X) solicits advertisements for Y and is able to factually prove that such solicitation is incidental to its (X's) business of producing television programmes,
- Where a commission agent sells goods of an enterprise in his own name and also habitually acts, in relation to the enterprise, as an agent having an authority to conclude contracts, he would be deemed in respect of the agency to be acting outside the ordinary course of his own trade or business.

5.35 Article 5(6) of the UN Model

Article 5(6) of the UN Model reads as follows:

"Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies."

Article 5(6) does not correspond to any provision of the OECD Model. A PE under Article 5(6) is based on the assumption that the agent through whom premiums are collected and risk insured, is present in the country (State of Source) where the risk is located. There are two exceptions in Article 5(6):

- It does not apply to reinsurance.
- If an insurance agent is independent, no PE exists.

5.36 Article 5(8) of the UN Model

Article 5(8) of the UN Model reads as follows:

"The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

Article 5(8) is clarificatory. It clarifies that a company of State of Residence is not deemed to have a PE in State of Source merely because it controls, or is controlled by, a company that is a resident of State of Source. The determination of whether a company is a PE of a related

company or not is to be made solely on the basis of the requirements under the other paragraphs of Article 5 and the mere existence or possibility of existence of close relationships is not sufficient to constitute a PE¹²⁵. Hence, the existence of a subsidiary does not, of itself, make that subsidiary company a PE of its parent nor is a PE constituted on account of identical shareholding.

Likewise, since each company constitutes an independent legal entity, the mere fact that the subsidiary company is managed by its parent or that the parent exercises strict control over activities of its subsidiary and desires stringent financial reporting, does not constitute the subsidiary a PE of the parent.

The above aspects were considered in the case of Carpi Tech SA¹²⁶. Based on facts and the provisions of Article 5 of the India-Switzerland tax treaty, the Chennai Tribunal held that the Indian subsidiary represented by its Managing Director constitutes a fixed place PE and a dependent agent in India.

5.37 Amendments to section 9(1)(i) by the Finance Act, 2018

As discussed earlier, the comparable term to PE under the Indian tax law is "business connection". Section 9(1)(i) of the Indian Income-tax Act provides that all income accruing or arising, whether directly or indirectly, through or from any business connection in India, shall be deemed to accrue or arise in India. The Finance Act, 2018 has brought in amendments to align the scope of 'business connection' under the Act with the recommendations of the BEPS Action Plan. The same are discussed hereunder.

5.37.1 Scope of "business connection" aligned with modified PE rule as per Multilateral Instrument

The OECD under BEPS Action Plan 7 reviewed the definition of 'PE' with a view to preventing avoidance of payment of tax by circumventing the existing PE definition by way of commissionaire arrangements or fragmentation of business activities. In order to tackle such tax avoidance scheme, the BEPS Action plan 7 recommended introduction of an anti-fragmentation rule and modifications to the Dependent Agent PE provisions of the DTAA. The recommendations under BEPS Action Plan 7 have now been included in Article 12 of Multilateral Convention to Implement Tax Treaty Related Measures (Multilateral Instrument - MLI), to which India is also a signatory. Consequently, these provisions will automatically modify India's bilateral tax treaties covered by MLI, where treaty partner has also opted for Article 12. However, as the provisions of the domestic law being narrower in scope are more beneficial than the provisions in the DTAAs as modified by MLI, such wider provisions in the DTAAs are rendered ineffective by virtue of section 90(2) of the Act.

Accordingly, with a view to align the domestic law with the DTAA as modified by the MLI, the Finance Act, 2018 has amended clause (a) of the Explanation 2 to section 9(1)(i) to provide that

¹²⁵DIT v E-Funds IT Solution (2014) 364 ITR 256 (Del HC), Adobe Systems Incorporated v ADIT (2017) 292 CTR 407 (Del HC)

¹²⁶(2017) 183 TTJ 264 (Chennai ITAT)

with effect from assessment year 2019-20, "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident, has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and the contracts are—

- (i) in the name of the non-resident; or
- (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
- (iii) for the provision of services by the non-resident.

5.37.2 “Business connection” to include “significant economic presence”

With the advancement in information and communication technology in the last few decades, new business models operating remotely through digital medium have emerged. Under these new business models, the non-resident enterprises interact with customers in another country without having any physical presence in that country. The existing provisions of the Act as well as the DTAA provide for nexus based on physical presence for taxation of business profit. Therefore, emerging business models such as digitized businesses, which do not require physical presence of the non-resident or any agent, are not covered within their scope.

OECD under its BEPS Action Plan 1 addressed the tax challenges in a digital economy wherein it has discussed several options to tackle the direct tax challenges arising in digital businesses. One such option is a new nexus rule based on “significant economic presence”. Accordingly, the Finance Act, 2018 has inserted an Explanation 2A to section 9(1)(i) to provide that with effect from assessment year 2019-20, 'significant economic presence' in India shall also constitute 'business connection'. For this purpose, 'significant economic presence' shall mean:-

- a) transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
- (b) systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means:

It is further provided that only so much of income as is attributable to such transactions or activities shall be deemed to accrue or arise in India and also that the transactions or activities shall constitute significant economic presence in India, whether or not the non-resident has a residence or place of business in India or renders services in India.

The above stated conditions are mutually exclusive. The threshold of “revenue” and the “users” in India will be decided after consultation with the stakeholders. Further, unless corresponding modifications to PE rules are made in the DTAAs, the cross border business profits will continue to be taxed as per the existing treaty rules.

5.38 Some recent rulings

5.38.1 Formula One World Championship Ltd (2017) 394 ITR 80 (SC)

The Supreme Court upheld the Delhi High Court's finding that the assessee has a fixed place PE in India by virtue of the international circuit i.e. place where the motor racing event is hosted. Accordingly the amounts received by it under the Race Promotion Contract constitute the assessee's business income. With a view to examine whether the international circuit was put at the disposal of the assessee so as to constitute its fixed place PE, the Supreme Court noted that the arrangement clearly demonstrated that the entire event was taken over and controlled by the assessee and its affiliates. The Court rejected the assessee's stand that since the duration of the event was only 3 days, the total duration for which limited access was granted to it was not sufficient to constitute the degree of permanence necessary to establish a fixed place PE; It clarified that the question has to be examined keeping in mind that the aforesaid race was to be conducted only for three days in a year and for the entire period of race the control was with the assessee. The Court also held that the construction or ownership of track or organising of events by the other party was immaterial as a common sense and plain thinking of the entire situation would lead to the conclusion that the assessee had earned income in India through the said track over which they had complete control during the period of race.

5.38.2 E-funds IT Solutions Inc (2017) 399 ITR 34 (SC)

The Supreme Court dismissed the Revenue's appeal and confirmed the Delhi High Court's ruling holding that the two US-based entities viz. eFunds Corporation USA and eFunds IT Solutions Group Inc., USA (assessee) did not have a fixed place PE, a service PE or an agency PE in India for assessment years 2000-01 to 2002-03 and 2004-05 to 2007-08. In terms of an agreement, their Indian subsidiary, e-Funds India performed back office operations in respect of ATM management, electronic payments, decision support and risk management services rendered by the assessee. The Supreme Court observed that the burden of proving the fact that a foreign assessee has a PE in India and must, therefore, suffer tax from the business generated from such PE is initially on the Revenue. Regarding constitution of a fixed place PE, it observed that the assessing officer, CIT (Appeals) and the ITAT have essentially adopted a fundamentally erroneous approach in saying that the assessee were contracting with a 100% subsidiary and were outsourcing business to such subsidiary, which resulted in the creation of a PE. It rejected the Revenue's reliance on US Securities and Exchange Commission Report in Form 10K as misplaced as it spoke about e-Funds group of companies worldwide as a whole and held that no part of the main business and revenue earning activity of assessee was carried on through a fixed business place in India which has been put at their disposal. It observed that the Indian company only renders support services which enable the assessee in turn to render services to their clients abroad. This outsourcing of work to India would not give rise to a fixed place PE. Regarding Service PE constitution through employees seconded by assessee to Indian entity, the Supreme Court noted that none of the customers of assessee had received services in India and only auxiliary operations were carried out in India, it thus held that as the very first part of Article 5(2)(i) is not attracted, the question of going to any other part of the said Article

does not arise. It also noted the High Court's observation that AO has not given any finding on nature of functions performed by seconded employees, whether they reported to E-Funds Corp/ Associated Enterprises while observing that this was not a correct way of deciding whether service PE existed. The Supreme Court also concurred with the High Court that it has never been the case of the Revenue that e-Funds India was authorized to or exercised any authority to conclude contracts on behalf of the US company, nor was any factual foundation laid to attract any of the said clauses contained in Article 5(4) of the DTAA.

5.38.3 Production Resource Group (2018) 401 ITR 256 (AAR)

The applicant was a Belgian company engaged in the business of providing technical equipment and services for events including lighting, sound, video and LED technologies. It entered into a Service Agreement with the Organizing Committee of the Commonwealth Games, Delhi to provide specified services on a turnkey basis. It rendered the services in conformity with the agreement for two days i.e. at the opening ceremony and at the closing ceremony of the Games. The applicant's employees and equipment were in India for a period of only 66 days for preparatory, installation and dismantling of equipment. The AAR held that the applicant had a PE in India as it was provided with a lockable place for storing its tools and equipment within the stadium i.e. where the revenue generating activity would take place. Coupled with the space, the lighting facilities erected by the assessee, were also held to be a part of the place of business. The contention that services were rendered only for two days was rejected on the basis that this was a turnkey project covering the entire duration of the Games and more. It also held that permanence of the place was to be gauged only for as much time as the business required. The AAR also considered certain other factors like sub-contracting of some of the activities, insurance of the project, mandatory licensing of the place, etc.

5.38.4 Seabird Exploration FZ LLC (2018) TS-162-AAR-2018 (AAR)

The AAR ruled that the assessee (a UAE tax resident) constitutes a fixed place PE in India under Article 5(1) of India-UAE DTAA in the form of its vessels engaged in seismic surveys on the high seas in connection with the exploration of mineral oil/ natural resources under its agreement with ONGC; It held that vessels used by the assessee passed all 3 tests for constituting PE under Article 5(1), namely that there was permanence of duration to the extent that is required by the business, there was a fixed place which are the vessels in the high seas in a definite and composite geographical area and from which its business of survey in connection with exploration is carried out and lastly this place was at the disposal of assessee. It rejected the assessee's contention that it cannot be considered as having a PE since it is covered by the specific clause under Article 5(2)(i) [which envisages furnishing of services such as supervision, managerial, consultancy, or general nature, which are employee or personnel oriented and connected with some works contract or project whose term aggregates to more than 9 months], as its period of operation was only 113 days. It opined that in contrast, services of seismic surveys are conducted on the high seas through the seismic vessels. They are not carried on mainly by employees/personnel but primarily by the vessels and equipment mounted thereon and deployed in the ocean; Such are not the services contemplated under para 5(2)(i) of the India UAE DTAA. The AAR further illustrated examples from the India-USA, India-

Netherlands, India-UK, India-Japan DTAA wherein specific mention of certain time period has been made in respect of an installation or structure used for the exploration or exploitation of natural resources for constituting a PE; It particularly referred to the India-Singapore DTAA which specifically provides that PE would be constituted if an enterprise provides services or facilities in that contracting state for a period of more than 183 days in any fiscal year in connection with the exploration, exploitation or extraction of mineral oils; Absent any mention with regard to activities in connection with exploration or connected activities in Article 5(2) of India-UAE DTAA, the AAR held that there is no scope for getting into the debate of interplay between paras 1 and 2 of Article 5 of the India UAE DTAA, or to resolve any conflict therein, since the services rendered by the applicant are not covered by any of the sub paras of para 2 of Article 5 or any other para.

5.38.5 Samsung Electronics Co Ltd (2018) 92 taxmann.com 171 (Del ITAT)

Samsung Electronics Co Ltd is a Korean company engaged in the business of manufacturing and sale of electronic products. Based on a mutual agreement, it deputed employees to its Indian subsidiary. The seconded employees worked under the supervision and direction of the Indian entity. The lower authorities held that the Indian subsidiary be treated as a deemed fixed place PE of the assessee as the services rendered by the expatriates were essentially for the benefit of the Korean company. The Delhi Tribunal observed that the communication by the expatriates covered information on the designs/ preference of the Indian consumers, stock status, market strategies, etc. This information would help the assessee to design products based on market preference, which will benefit the Indian entity. The Tribunal thus held that the assessee did not have a PE in India as the expatriates were only discharging their functions as employees of the Indian subsidiary, and not conducting any business of the foreign company in India. It further held that even if it was considered that the assessee was rendering services to the Indian subsidiary through the seconded employees, there would not arise a service PE in the absence of a service PE clause in the India-Korea DTAA provisions as applicable to the relevant assessment year.

5.38.6 Master Card Asia Pacific Pte. Ltd. AAR No.1573 of 2014 dated 06.07.2018

The Applicant, a Singapore based company and a leading global payment solution provider, used to charge banks [with whom it entered into Master License Agreements] processing fees relating to authorization, clearing and settlement of transactions. The Applicant provided the banks with a MasterCard Interface Processor (MIPs) that connected to the Mastercard Network and other processing centres. The MIPs were owned by the Indian subsidiary of the Applicant. The Applicant sought a ruling from AAR on the following issues i) Whether the digital equipment (MIP) created a PE (ii) Whether the MasterCard Network created a fixed place PE in India (iii) Whether agency relationship is created through Bank of India and its premises would constitute a fixed place PE (iv) Whether Applicant's subsidiary (MISPL) created a fixed place PE (v) Whether there was creation of a PE through the Applicant's visiting employees (vi) Whether there was a dependent agent PE created through MISPL On the first issue, the AAR accepted Revenue's stand that even an automatic equipment can create a PE and did not have to be fixed to the ground to constitute a fixed place PE. It held that since significant functions were

performed by MIPs in facilitating authorization process and the MIPs were at the disposal of the Applicant, the MIPs constituted PE on account of the test of disposal and permanence being satisfied.

In case of the second issue, it noted that apart from MIP, transmission towers, leased lines, fiber optic cable, nodes and internet (owned by third party service provider) and application software which constituted the Mastercard Network were located in India as well as outside India. It also noted that the task performed by the MasterCard Network were significant activities in the context of overall functions of transaction processing rendered to third party and not preparatory or auxiliary. Further, noting that the Applicant owned part of the Network, the AAR held that the Network also constituted PE.

With respect to issue (iii), noting that the settlement activities happened through Bank of India who carried out the functions under the instructions of the Applicant, it accepted revenue's contention that the Bank of India premises where settlement activities happened through employees created a fixed place PE.

The AAR noted that MCI (of which Applicant was a wholly owned indirect subsidiary) had a liaison office ('LO') in India and for which the Applicant had disclosed income from transaction processing service rendered in India at full 100% attribution of global net profit rate. Once the Applicant in the case of LO had legally accepted a PE on account of 100% attribution of profit to India, now MISPL also created a PE of the Applicant.

The AAR, while examining whether the work carried out by the Applicant's employees visiting India was a part of transaction processing services, concluded that the work was an integral part of the Applicant's profession to provide new avenues of services to clients. Thus, it held that the employees visiting India were providing services to clients, and if they exceeded the threshold of 90 days in a year, a service PE could be created.

The AAR noted that the agreement concluded by the Applicant was routed through MISPL who brought the proposal though it was finalized by the Applicant. The above action of MISPL satisfied the requirement of securing order under Article 5(8) of DTAA and thus, MISPL constituted a dependent agent PE.

5.38.7 GE Energy Parts Inc. (2019) 411 ITR 243 (Delhi High Court)

In a recent ruling, Delhi High Court confirmed the ITAT order upholding the constitution of fixed-place PEs as well as dependent-agent PEs (DAPEs) for 24 GE group entities, citing GE Energy Parts Inc. (the taxpayer, a US based group company) as the lead case. Pursuant to a survey conducted at the liaison office (LO) premises in India of General Electric International Operations Company Inc (GEIOC, one of the overseas group entities) by the tax authorities, it was observed that expatriates were deputed in India to undertake the marketing activities/sale functions of the overall GE group. Accordingly, the tax officer held that the LO constituted the taxpayer's fixed-place PE. The tax officer also held that "GE India" consisting of expatriate employees of the GE group entities and the employees of GE India Industrial P Ltd (GEIPL) constituted the taxpayer's dependent agency PE in India.

The key observations of the High Court:

Constitution of fixed-place PE in India

Upon perusal of the relevant provisions of the India-US DTAA and OECD Model Tax Convention, the high Court held that the term “place of business” had to be understood to mean any premises, facilities or installations used for carrying on the business of the enterprise. Moreover, having space at disposal did not require a legal right to use that place - mere continuous usage was sufficient if it indicated being at disposal. The Court ruled that, as per article 5(1) of the DTAA, GE’s overseas enterprises had a place of business in India.

The High Court placed reliance on the Supreme Court decision in the Formula One case [TS-161-SC2017]. The Court noted that GE India was located in the space leased by GEIOC in the AIFACS building, New Delhi which was at its constant disposal. Further, the specific chambers/rooms and secretarial staff were allotted to GE staff, which were used for their work, thereby ensuring continuity of space available. The Court rejected the taxpayer’s argument that there was a difference between sales made from the AIFACS building and the presence of GE India employees at the premises. Moreover, it was professed that merely because expatriates and employees were found at the premises could not lead to the conclusion that the sales were made from that place. The Court concurred with the Tribunal’s findings that the core of the sales activity was done from the AIFACS building. The Court stated that as GE had not contested that the premises were indeed used for activities of some form, it was reasonable to assume those activities occurred through the premises. Thus, the Court opined that, “GE’s activities in India are wholly or partly carried on through its fixed place of business. The term “through which” is to be given a wide latitude – when business is carried out at a particular location at the disposal of an enterprise, it is sufficient to say it meets the “through which” threshold.

Exclusion of preparatory and auxiliary activities

The High Court then considered the taxpayer’s argument that its activities were within the ambit of article 5(3) that excluded applicability of article 5(1), i.e. that the premises were used for other activities that had a preparatory or auxiliary character. The Court referred to various judicial precedents to examine whether the activities carried out in India could be treated as preparatory or auxiliary services, such as the ruling in National Petroleum Construction Company [TS-29-HC-2016(DEL)], the Supreme Court decision in the case of E-Funds IT Solution Inc. [TS469-SC-2017], Morgan Stanley, UAE Exchange and the Karnataka High Court decision in the case of Jebon Corporation India.

The taxpayer had argued that GE expatriate and employees did not have the authority to conclude/negotiate contracts, which was necessary to hold that activities were not auxiliary or preparatory in nature. The Court noted that article 5(3) made no mention of the authority to conclude contracts, which was explicitly used in article 5(4)(a) dealing with agency PEs. Accordingly, the Court held that reading such conditions in a preparatory/auxiliary clause would erode a key distinction between a fixed-place PE and an agency PE.

Moreover, the Court noted the Tribunal's findings regarding the process adopted for business development. The process consisted of four steps: Stage 1 - Pre-qualification; Stage 2 - Bid/no bid and Proposal development; Stage 3 - Bid approval and negotiations; and Stage 4 - Final contract development and approval. The Court opined that the process of sales and marketing of GE's product through its various group companies, in several segments of the economy (gas and energy, railways, power, etc.) was not simple. Entering into a contract with stakeholders (mainly service providers in these segments) involved a complex matrix of technical specifications, commercial terms, financial terms and other policies of GE. Therefore, to address these, GE had stationed several employees and officials. The Court noted that, at one end of the spectrum of their activities, was information gathering and analysis (which helped develop business and commercial opportunities), whereas, at the other end, were intensive negotiations with respect to change of technical parameters of specific goods and products, which had to be made to suit the customers. The Court noted that the above process was time consuming and involved a series of consultations between the client, its technical and financial experts and also its headquarters. Upon perusal of e-mail communications and chain mails with clients, the Court noted that they appeared to show important roles of GE India employees in the negotiating process.

The Court held that the taxpayers' employees were not merely liaising with the clients and the headquarters office but the core activity of GE India involved discussing the contractual terms and the associated consideration payable, the warranty and other commercial terms. Acknowledging that at later stages of contract negotiations, the India office could not take a final decision, but had to await the final word from headquarters, the Court ruled that this would not mean that the India office was just for mute data collection and information dissemination.

The Court concluded that the discharge of vital responsibilities relating to the finalization of commercial terms etc. clearly revealed that GE carried on business in India through its fixed place of business.

Constitution of Agency PE

The taxpayer had relied on the OECD Commentary on Model Tax Convention (paragraph 33 on Article 5), which unambiguously states that mere participation in negotiation does not lead to either a fixed-place PE or a DAPE. It was argued that the view taken by the Tribunal is not only contrary to the OECD Commentary but also to the UN Commentary on Model Tax Convention (paragraph 24 on Article 5) as well as settled jurisprudence under Indian contract law, wherein it is specifically recognized that the authority to negotiate is different from the authority to conclude contracts. Thus it was claimed that unless the agent is authorized to conclude all elements (or at least critical elements of the contract), he cannot be said to have the authority to bind the principal.

The Court noted that India had clarified its position that it does not agree with the above portions of paragraph 33 of the Commentary. Further, the Court noted that the position in paragraph 32.1 runs contrary to paragraph 33 of the OECD Commentary relied upon by GE. Therefore, it held that the taxpayer cannot selectively quote from certain parts of the Commentary – rather, he

must take into account the spirit of the entire commentary. Noting that paragraph 32 of the OECD Commentary says that lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent, the Court remarked that, “since the OECD commentary appears to be contradictory across paragraphs 32 and 33, it cannot be relied upon wholly.” The Court relied on the opinion of Philip Morris in this regard that the participation of representatives or employees of a resident company in a phase of the conclusion of a contract between a foreign company and another resident entity may fall within the concept of authority to conclude contracts in the name of the foreign company.

Next, the Court rejected the taxpayer’s stand that the activities of the agent must be devoted wholly or almost wholly to one enterprise. Further, the taxpayer had argued that the expatriates and employees of GEIPL without doubt participated in the negotiation for conclusion of contracts, but never had the authority, whether expressed or implied, to finalize any contract of their own volition. These staff, even though highly qualified, did not have any authority to bind the foreign enterprises. Thus, GE urged that, given the absence of an authority to conclude contract, there could not be a DAPE. The Court remarked “Enterprises, we note, do not necessarily organize the business principles on which they function into neat pigeon holes that the DTAA’s envision. The ingenuity and innovation of the enterprise – indeed its intangible wealth is to aggregate and maximizing profits in the most efficient manner possible, even while minimizing costs. The DTAA’s and indeed tax regimes are based on known patterns of such organizational behaviour.” The Court ruled “The intricate nature of activities it has carefully designed, where technical officials having varying degree of authority involve themselves – along with local managerial and technical employees, in contract negotiation, often into core or “key” areas, modification of technical specifications and the negotiations for it, to fulfil local needs and even local regulatory requirements, the complexities of price negotiation, etc. clearly show that the Taxpayer carries out through the PE business in India. These activities also intersect and overlap with the content of the principle of dependent agent, inasmuch it is evident that these agencies work solely for the overseas companies, in their core activities.”

Attribution of Profits

The Court upheld the Tribunal’s two-stage analysis for profit attribution purpose with regard to (i) estimating income at 10% of the sales made in India and (ii) attributing 26% of such profit to the marketing activity carried out by the PE in India.

5.38.8 Judicial Pronouncements

FCC Co. Ltd. v. ACIT [2022] 136 taxmann.com 137 (Delhi - Trib.)

It was held that no PE of the Japanese JV partner, whether Fixed Place PE or Supervisory PE, can be said to exist in India when it renders agreed engineering services not of supervisory nature, in premises of its Indian JV over which it has no control. It was also held that no part of the consideration received by the Japanese JV partner for offshore supply of raw materials, components and capital goods under Master Sales Agreement to Indian JV partner accrued in India, as sale of goods took place outside India and consideration accrued outside India.

ESPN Star Sports Mauritius SNC et Compagnie v. DCIT [2022] 134 taxmann.com 251 Delhi – Trib.

Assessee-partnership firm, incorporated under laws of Mauritius, was engaged in business of acquiring and allotting advertisement time ('Airtime'). It entered into an agreement with Indian entity which was engaged in business of acquiring airtime from assessee and allotting it to various Indian advertising agencies. Assessing Officer held that the Indian entity constituted Dependent Agent Permanent Establishment (DAPE) of assessee as per article 5 of India-Mauritius DTAA and attributed part of gross revenue from India as profits to said Indian entity. Indian entity was remunerated at arm's length price by assessee, which was also accepted by TPO of both entities. It was held that where Indian company only rendered support services which enabled assessee in turn to render services to their clients abroad, this outsourcing of work to India would not give rise to a fixed place PE. Thus, there was no business connection for assessee in India in terms of section 9(1) and no PE and, thus, no further attribution of profits was to be made.

6. Article 6 –Income from Immovable Property

6.1 Background

Article 6 in all tax treaties deals with income from immovable property, except treaty with Greece wherein it is dealt with in Article 10. Even Article 6 under all the 3 Model Conventions issued by Organization for Economic Co-operation and Development ('OECD'), United Nations ('UN') & United States ('US') deals with income from immovable property. One must take care, that Article 6 generally deals with the income from letting or use of immovable property and does not deal with capital gains arising on transfer of immovable property, which is generally dealt by Article 13 (Capital Gains). In this chapter following points are dealt with in regard to taxability of income from immovable property:

- a) General structure of Article 6 in tax treaties;
- b) Article 6 in model conventions;
- c) Taxing right of income from immovable property;
- d) Meaning of 'immovable properties';
- e) Nature of income covered under Article 6;
 - Scope of income of immovable properties;
 - Income from agriculture and forestry;
 - Income from immovable properties in the case of permanent establishment and independent personal services;
- f) Computation of income from immovable properties; and
- g) Reference material.

6.2 General Structure of Article 6 in tax treaties

General structure of Article 6 in tax treaties is as under:

- Para 1 – Deals with taxing right of the state. Almost all the tax treaties give the taxing right to the state where immovable property is situated;
- Para 2 – Defines immovable property;
- Para 3 – Scope of income arising from immovable property;
- Para 4 – Deals with income earned from immovable property by an enterprise and income from immovable property used for the performance of independent personal services

Majority of the tax treaties has 4 paragraphs with the exception of Australia, Finland, Kyrgyz Republic, Namibia and Portuguese Republic which have 5 paragraphs. Further, among the model tax treaties, US Convention has Para 5 dealing with the option of taxability of income on net basis as being attributable to permanent establishment.

6.3 Model Conventions

OECD Model Convention is as under:

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture and forestry) situated in the other Contracting State may be taxed in that other State.
2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.
3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.
4. The provisions of paragraphs 1 and 3 of this article shall also apply to the income from immovable property of an enterprise.

UN Model Convention is also almost similar to OECD except with the difference in Para 4 which includes reference to income from immovable property used for the performance of independent personal services. This change is consequential to the fact that Article 14 on independent personal services is retained in UN Model Convention and the same is deleted in OECD Model Convention.

Further, US Model Convention is almost similar to OECD and UN Model Convention with the following differences:

- It refers to real property instead of immovable property;
- Definition of 'immovable property' refers to the laws of contracting state. It does not contain specific inclusions and exclusions as mentioned in OECD and UN Model convention; and
- Contains additional Para 5 as discussed above.

6.4 Taxing Right of Income from Immovable Property

In all the Treaties and Model tax conventions, the primary right to tax the income from immovable property is with the Contracting State where the immovable property is situated. The situs i.e. place of the immovable property has vital role in determining the taxation rights of the contracting states on the income from such immovable property. This is because of the fact that there is always a very close economic connection between source of this income and the state where property is situated, as compared to the state where the recipient of such income resides.

Tax treaties signed by India has following variations:

- Majority of tax treaties have used the words "Income derived from" like Denmark, Finland, France, Japan, etc. Whereas certain tax treaties have used the words "Income from" like United Kingdom, Australia, Belgium, Canada, etc.

Though lot of controversy is experienced in India on the use of word 'derived from' in the context of tax holidays and tax incentives, no major controversy is experienced in the context of Article 6.

- Majority of the treaties has used the words 'may be taxed in the contracting state in which the property is situated'. Whereas treaties with Egypt, has used the words "shall be taxed". Further, in the treaties with Bangladesh, Egypt and Greece words used are "be taxable only in the contracting state where property is situated'.

The above variation in the wordings of tax treaties, indicates that the treaties wherein the words "may be taxed" have been used are not giving exclusive right of taxation to the state of source, but the nature of such right is primary and hence, the state of residence i.e. where the recipient of income resides may also tax the same income. Whereas, tax treaty with Bangladesh, Greece and Egypt provides exclusive right to the state of source to tax income from immovable property.

Hon'ble Supreme Court in the case of CIT vs. P.V.A.L. Kulandagan Chettiar [2004] 137 Taxman 460 (SC), has dealt with the above issue in the context of India Malaysia Tax Treaty. Article 6 of the then India Malaysia tax treaty states that "Income from immovable property may be taxed in the contracting state in which such property is situated'. Hon'ble Supreme Court has held that "business income out of rubber plantations cannot be taxed in India because of closer economic relations between the assessee and Malaysia in which the property is located'. Post this decision of Hon'ble Supreme Court, various other high courts and tribunals have taken similar view in this regard. However, it may be noted that paragraph 3 of the Protocol to the 2012 India Malaysia tax treaty specifically states

as follows -" It is understood that the term "may be taxed in the other State" wherever appearing in the Agreement should not be construed as preventing the country of residence from taxing the income."

Further, Central Board of Direct Taxes ('CBDT') vide Notification 91/2008 dated 28.08.2008 has clarified that, in case tax treaty 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 and relief shall be granted in accordance with the treaty provisions.

6.5 Meaning of immovable Property

The meaning of immovable property as envisaged in the Model Conventions can be divided into following parts:

1. Meaning as per the domestic law of the contracting state where the immovable property is situated;
2. Specific inclusions – certain items to be always regarded as immovable property;
3. Specific exclusions - this refers to certain items not to be regarded as immovable property;

6.6 Meaning as per domestic law

The immovable property shall have the meaning which it has under the law of the contracting state in which the property in question is situated. The meaning may be drawn from the tax law of the contracting state where the immovable property is situated and if tax law does not define immovable property reliance can be placed on general law prevailing in the aforesaid state. This view draws its support from Article 3(2) of the Model Tax Convention (both UN & OECD) which from the outset gives priority to the meaning as given in tax law of the concerned state over other laws for the terms not defined in the treaty.

In the Indian Income-tax Act, immovable property is defined under Section 269UA of the Act. However, Section 269UA states that "In this Chapter, unless the context otherwise requires". This gives a clear indication that meaning provided in Section 269UA of the Act is only for the purpose of Chapter XX-C. In view of the same, one has to consider whether this definition can be used for the purpose of interpretation of tax treaty. However, since no definition is provided under Section 2 of the Act, one can rely on the definition provided under Section 269UA of the Act.

In case if one takes a view that the definition under Section 269UA cannot be used for the purpose of interpretation of immovable property under the treaty, then one can take recourse to the General Clauses Act, 1897 in India, which defines that immovable property shall include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth.

6.7 Specific Inclusions

There are some specific inclusions in the definition of immovable property, which shall always be considered as 'immovable property' even if not considered as 'immovable property' under normal parlance or under the domestic laws of the contracting state where the property is situated. These specific inclusions are:

- Property accessory to immovable property - Property accessory or appurtenant property generally should include buildings, machines on the land or furniture in a house or such similar assets which may or may not be attached to land, but contribute in generating income in a composite form along with primary/principal immovable property. For the purpose of determining whether an accessory property is attached to an immovable property, should be treated as an immovable property, object and purpose of attachment of such accessory property is important. The degree and nature of attachment no doubt should be a consideration, but the more important consideration should be the object of attachment which is a question of fact to be determined by the circumstances of each case. If a thing is embedded in the earth or attached to something which is already embedded for the permanent beneficial enjoyment of such property to which it is attached, then it is a part of immovable property.
- Livestock and equipment used in agriculture and forestry – Since income from agriculture or forestry is to be considered as income from immovable property, Livestock and equipment which are used in the activities of agriculture and forestry shall also be included within the meaning of immovable property.
- Rights to which the provisions of general law respecting landed property apply - This involves right to develop (construct) the property, right to acquire land or buildings. Aforesaid rights shall be considered to be situated where such immovable property is situated and the income from such rights shall be taxed accordingly in the state where the immovable property is situated.
- Usufruct of immovable property - This involves rights such as right in a co-operative society which entitles a member to a flat or an apartment or easements or similar rights arising from immovable property.
- Rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources - Rights attached to extraction of natural resources is regarded as immovable property. Such rights attached to extraction may be variable or fixed payments.

6.8 Specific Exclusions

Ships, boats, aircrafts are not regarded as immovable property. Profits derived from the operations of ships, boats or aircrafts are governed by Article 8.

6.9 Definition of immovable property in Indian Tax Treaties

Tax Treaties entered by India are more or less on the similar lines as provided in model conventions. However, there are certain deviations observed in certain tax treaties like –

- Boats are not excluded in some treaties like UK, Romania, Belgium, Brazil, etc. Whereas some treaties have excluded other assets also from the definition of immovable property like Kyrgyz Republic has specifically excluded railway vehicles, Mongolia has excluded land vehicles, etc.
- In line with, US Model Convention, US and Libya refer only to the definition as per domestic laws i.e. these tax treaties do not have any specific inclusions and exclusions.
- Turkey includes fishing places of every kind within the meaning of ‘immovable property’.

6.10 Nature of income covered under Article 6

Income from immovable property includes income earned by the use or lease of immovable property. Further, capital gains or taxation of immovable property (akin to wealth tax), is dealt separately by Article 13 and Article 22.

6.11 Scope of income of immovable properties (Paragraph 3)

All forms of income earned from the exploitation of immovable property, be it direct or indirect is covered under Article 6. Every kind of income sourced from immovable property falls within the domain of Article 6 and may be taxed in the state of location of such immovable property.

Paragraph three specifically prescribes direct use and letting. The term ‘letting’ has not been defined in the convention/ treaty, therefore it will be defined according to the laws of the state where the immovable property is situated. Also, the term includes income from sub -letting. However, income in the form of interest earned by securing debt through immovable property is governed by Article 11 relating to interest. Further compensation received for waiving rights under long-term leases of immovable property falls within the ambit of Article 6.

6.12 Income from agriculture and forestry

Model Tax Conventions and various tax treaties have also included income from agriculture and forestry within the ambit of income from immovable property. Naturally, it may be due to the fact that these incomes primarily concern the use of land.

With regard to income from agriculture and forestry, Indian tax treaties have shown a varied trend, i.e. few of the treaties do refer to income from agriculture and forestry as a part of income from immovable property whereas other treaties do not refer to the same as being part of income from immovable property. The treaty with Armenia, Austria, France, Indonesia, etc. include whereas, treaties with Australia, UK, Belgium, Brazil, China, Denmark, Japan, etc. do not include income from agriculture and forestry under Article 6.

However, one must observe that in the treaties where such income is not included in Article 6,

definition of immovable property under Paragraph 2 includes livestock and equipment used for the purpose of agricultural and forestry activity.

In cases where income from agriculture and forestry is not covered in Paragraph 1, such income is likely to be governed by Article 7 –business profits article. However, in majority of the cases the concerned person is likely to have a permanent establishment in India and the corresponding income is likely to be taxable under Article 7.

6.13 Income from immovable properties in the case of permanent establishment and independent personal services

Paragraph 4 makes it clear that the provisions of paragraphs 1 and 3 apply also to income from immovable property of industrial, commercial and other enterprises. . Also, if a permanent establishment is engaged in the business of trading or managing immovable property, such business income also falls under paragraph 4 of Article 6 and not under Article 7.

6.14 Income from immovable property situated in the third country

The commentary on Model Conventions has made it clear that Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in a third state.

In a situation where a resident of one of the Contracting State earns income from immovable property located in a third state, it falls outside the ambit of Article 6 and comes within the article of 'Other Income' and taxed accordingly.

6.15 Computation of income from immovable property

Article 6 mainly deals with attribution of taxing rights, definition of immovable property, nature of incomes covered under immovable property. However, it has not prescribed any specific mode of computation of income. In the absence of any specific method, income from immovable property is to be computed as per the domestic tax laws of the state where the property is situated.

6.16 Computation as per domestic tax laws

Immovable property as discussed above, covers various accessory properties, agriculture and forestry, etc. within its ambit. In view of the same, income may be computed in any of the following ways:

- Income from land and house property may be taxed as per the provisions of Chapter IV-C of the Act– Income from house property. However, under Chapter IV-C only land and house property is covered where as in Article 6 various other kinds of immovable properties are covered to which provisions of Chapter IV-C may not apply.
- The Assets to which provisions of Chapter IV-C will not apply, may be taxed as per the

provisions of Chapter IV-D – Profits and gains of business or profession or Chapter IV-F Income from Other Sources.

- Though income from agriculture and forestry activity is taxable in India for the properties situated in India, however, the same may not be taxable under Section 10(1) of the Act under agricultural income.

6.17 Taxation as profits attributable to PE as per option provided under US Model Convention

US Model Convention provides that the assessee may elect for any taxable year to compute the tax on such income on net basis as if such income were business profits attributable to a permanent establishment in such other state. US Model convention, further provides that if , any such option is exercised then it shall be binding for the taxable year of the election and all subsequent taxable year unless the competent authority of the Contracting state in which the property is situated agrees to terminate the option.

6.18 Recent ruling

Bank of India (2017) TS-515-ITAT-2017 (Mum ITAT)

The Mumbai ITAT held that rental income earned by the assessee-bank from house property at Kenya was not taxable in India in view of the benefit conferred by Article 6 of India-Kenya DTAA. The Revenue had treated the business income and house property income as one source of income for tax purposes. Further relying on CBDT notification No.91 of 2008, the Revenue held that exclusion of rental income was not allowed. Rejecting the Revenue's stand, ITAT noted that the DTAA contains two different Articles, whereby business income is governed by Article 7 and Article 6 deals with house property income. The ITAT further clarified that any notification or circular cannot alter the nature of income that has been specifically included in DTAA. It held that even an amendment in a section of the Act would not affect the provisions of tax treaties, unless the same are not rectified by both the signatories of the treaty.

6.19 Reference Material

Students may refer to following study material for further detailed analysis:

- OECD Model Commentary 2014
- UN Model Commentary 2011
- US – MTC Technical Explanation 2006
- International Taxation – A Compendium – 3rd Edition – Chapter 28 Income from Immovable Property Authored by Mr. Manoj Shah
- The Law and Practice of Tax Treaties – An Indian Perspective – Authored by Mr. Nilesh Modi
- Klaus Vogel on Double Taxation Conventions

- Double Taxation Conventions and International Tax Law, by Philip Baker

7. Article 7–Business Profits

7.1 Background

Article 7 deals with taxability of business profits of an enterprise. It contains the rules for taxation and ascertainment of the profits of a foreign enterprise doing business in State of Source.

Article 7(1) provides the basic rule regarding the taxing rights of State of Residence and State of Source in relation to the business profits of an enterprise. Articles 7(2) to 7(5) contain rules for computing profits that are attributable to PE. These are machinery provisions which do not create any liability to pay.

7.2 OECD Report

The OECD has published detailed report on attribution of profits to PE ("The OECD report"). The report is divided into four parts:

Part I: General considerations.

Part II: Special considerations for PEs of banks.

Part III: Special considerations for PEs of enterprises carrying on global trading of financial instruments.

Part IV: Special considerations for PEs of insurance enterprises.

The report focuses on determining the preferred interpretation and application of Art 7 (referred to in the Report as the Authorised OECD approach).

The conclusions in the report are in some areas different from the current practices especially the part relating to the Authorised OECD Approach (AOA). The UN is not likely to accept the AOA¹²⁷.

7.3. Article 7(1) of the UN Model

Article 7(1) of the UN Model reads as follows:

"The 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. 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 is 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

¹²⁷New Capital Allocation Rules for Permanent Establishments, Nilesh Kapadia, The Chartered Accountant, February 2012, p. 88

establishment."

Paraphrasing, Art 7(1) provides as follows:

- State of Source can tax the profits of an enterprise of State of Residence only if: the enterprise carries on business in State of Source; and such business is carried on through a PE in that State of Source.
- If the above conditions are not fulfilled, the profits can be taxed only in State Residence. However, if both the conditions are fulfilled, State of Source can tax only so much of the profits of the enterprise as are attributable to:
 - the PE [Art 7(1)(a)];
 - sales in State of Source of same or similar goods or merchandise as those sold through that PE [Force of Attraction (FOA) Rule, Art 7(1)(b)]; or
 - other business activities carried on in State of Source of the same or similar kind as those effected through that PE. [FOA Rule, Art 7(1)(c)].

The aforesaid rules do not apply to profits of businesses dealt with by Art 8 (Shipping profits), 10 (Dividends), 11 (Interest) or 12 (royalties) which can be taxed under these articles even in the absence of a PE. However, these rules would apply to business profits dealt with by Art 10 to 12 to the extent they are effectively connected with the PE. If a treaty does not have an article for "fees for technical services", then the business profits in the form of fees from technical services cannot be taxed in the absence of a PE. In many cases, fees for technical services are included in the Article on Royalties, in which case the same will need to be followed, rather than the general rule in Article 7.

The provisions of Art 7 are general in nature and have to be read subject to the provisions of Art 24.

7.3.1 Definition of profits / business profits

While the title of Art 7 refers to "Business Profits", the language in Art 7 refers only to "profits". However, it is obvious that Art 7 is meant to cover taxation of "business profits". The term "profits" is not defined in the Convention. It has a wide meaning and includes income derived in carrying on an "enterprise". The expression "business profits" is also not defined in the Convention. It is intended to cover income from any trade or business.

7.3.2 Taxation in State of Residence

It has been held by the Supreme Court¹²⁸ that State of Residence cannot tax its residents in respect of the profits of a PE of such resident in State of Source once an income is held to be taxable in a tax jurisdiction under a treaty, then unless there is a specific mention in the said treaty that such income can also be taxed in the other tax jurisdiction, that jurisdiction is denuded

¹²⁸ CIT Vs R M Muthaiah (1993) 202 ITR 508 (Kar) ; CIT Vs VSRM Firm (1994) 208 ITR 400 (Mad); CIT Vs Ramaswami Chettiar (1995) 211 ITR 368 (Mad) [see also CIT Vs Lakshmi Textile Exporters Ltd (2000) 245 ITR 521 (Mad)]; DCIT Vs Patni Computers Ltd (2007) 109 TTJ 742.

of its taxing powers. This view has been distinguished in certain other judgments, and the general view appears to be that the right of State R to tax the income of its residents is supreme, and would continue de hors any treaty. State R may be required to provide credit of foreign taxes paid in State S to avoid double taxation based on the provisions of the tax treaty.

7.4 Article 7(1)(a) of the UN Model: Taxation of profits attributable to a PE

Article 7(1)(a) contains the general rule normally found in most tax treaties, that, in the absence of a PE, State of Source cannot tax the business profits of a foreign enterprise. As such, State of Source has a right to tax profits attributable to a PE; but such right is not available in respect of profits that the foreign enterprise may derive from State of Source otherwise than through a PE. Accordingly, if any Losses are incurred by the foreign enterprise in connection with transactions not attributable to a PE (e.g. direct transactions by head office), the same may not be set off against a PE's profits.

Article 7(1)(a) by itself, does not have any "force of attraction" (FOA) principle¹²⁹. In order to avoid abuse, the Protocol to the India-Germany Tax Treaty provides as follows:

"In respect of paragraph 1 of Article 7, profits derived from the - sale of goods or merchandise of the same or similar kind as those sold, or from other business activities of the same or similar kind as those effected, through that permanent establishment, may be considered attributable to that permanent establishment if it is proved that:

- i. this transaction has been resorted to in order to avoid taxation in the Contracting State where the permanent establishment is situated; and
- ii. the permanent establishment in any way was involved in this transaction.

Article 7(2) provides that "there shall be attributed to that PE", thus the determination of profits attributable to a PE is governed by Art 7(2) and hence, Art 7(1)(a) should not be so interpreted as to contradict Art 7(2). In other words, in the absence of a specific provision for a FOA, the profits taxable in State S need to be arrived at by following Article 7(2) alone, and hence ignoring any transactions made by the Head office or its PE in any other State made with State S.

7.4.1 Operations outside State of Source

Profits which could be attributable to a PE may be from its operations within or outside State S. Certain Indian treaties allow State of Source to tax a PE only for activities carried on by it (PE) in State of Source. The AAR in the Betchel Case (P No. 13 of 1995), in the context of the India-France Tax Treaty, held that the said treaty allows State of Source to attribute only the actual activities carried on by the PE in State of Source and not outside State of Source.

¹²⁹ Discussed later

7.4.2 Attributable to

The second sentence of Art 7(1) allows State of Source to tax only those profits which are economically attributable to the PE, that is, those which result from the PE's activities, and which arise economically from the business carried on by the PE. It is generally understood as profits arising economically from the activities/ business done through the PE. There needs to be a direct economic nexus with the PE.

The concept of "attributable to" is similar to, but somewhat different from the concept of "effectively connected". The Technical Explanation to the India-US Tax Treaty states that the concept of "attributable to" is narrower than the concept of "effectively connected". However, the US Model Commentary states that in some cases, the amount of income attributable to a PE under Art 7 may be greater than the amount of income that would be treated as "effectively connected" to such PE and there could be items of income which are attributable to a PE but not "effectively connected" with it and vice versa.

The views of various Indian judicial authorities in the context of certain sections forming part of Chapter VI A of the Income tax Act, 1961, (e.g. 80I, 80 IA, 80 HH, 80 HHC, etc.) could be relevant while deciding on the meaning of the words "attributable to" or "effectively connected".

7.4.3 Directly or indirectly

Certain Indian treaties allow State of Source to tax such profits as are directly or indirectly attributable to the PE. For profits to be attributable "directly or indirectly", the PE should be involved in the activity giving rise to profits and profits derived independently of the PE are excluded. Accordingly, the usage of these words "directly or indirectly" does not result in application of any specific or implied FOA rule as embedded in Art7(1)(b) and (c) of the UN Convention.

Some of the Indian treaties regard profits proportionate to the contribution of the PE in initial activity of negotiating, concluding or fulfilling contracts (entered into by the foreign enterprise) as profits "directly or indirectly attributable" to PE.

7.4.4 Turnkey Contracts

A turnkey contract for erection of machinery, factory building, etc. involves:

- offshore supply of goods;
- onshore supply of goods;
- offshore services;
- onshore services in State of Source; and
- supply of designs.

Turnkey projects include components other than construction/ installation activities, such as offshore supply of goods and offshore services. These items (offshore supply of goods and offshore services) may be performed outside State of Source before the construction activities begin in State of Source. In such a case, some jurisdictions attribute the entire profits of the turnkey contract (including offshore supply of goods and offshore services) to the PE while some

others are of the view that only the profits attributable to construction/installation activities carried on by the PE should be taxed in State S.

In the context of Art 7 of the India-Japan Tax Treaty, the Supreme Court¹³⁰ has observed as follows:

- The fact that a contract has been termed as turnkey contract may not be of much significance.
- The mere fact that a contract is a turnkey contract does not by itself mean that even for the purpose of taxability, the entire contract must be considered to be an integrated one.
- If the payment for offshore and onshore supply of goods and services was in itself clearly demarcated, the contract cannot be held to be a complete contract that has to be read as a whole and not in parts.
- Where different severable parts of a composite contract are performed in different places, the principle of apportionment can be applied to determine which jurisdiction can tax that particular part of the transaction.
- No part of offshore supply of goods and services could be taxed in State of Source since the PE has no role to play in this connection.
- The entire income arising out of a turnkey project would not be assessable in State of Source merely because the non-resident taxpayer has a PE in State Source.
- The taxable events in execution of a contract may arise at several stages in several years.
- The aforesaid principles are not influenced merely because the contract is signed in State of Source or because offshore services are utilised in State of Source.

Later in CIT v Hyundai Heavy Industries Co Ltd, the Supreme Court,¹³¹ in the context of the India-Korea Tax Treaty, reiterated the above principles and observed as

- While it is not an absolute rule, generally speaking, in the case of a turnkey project, a PE is set up at the installation stage while the entire turnkey project, including the sale of equipment, is finalised before the installation stage. The setting up of a PE, in such a case, is a stage subsequent to the conclusion of the contract. It is as a result of the sale of the equipment that the installation PE comes into existence.
- Thus, offshore supply of material cannot be taxed in State of Source since the installation PE came into existence only after offshore supply. Consequently, profits attributable to offshore supply cannot be attributed to the "installation PE".
- Even if the material supplied by the head office is necessary for the purposes of installation activities (activity of the PE) and even if it is assumed that the supplies were an integral part of the installation activities, still no part of the profits can be attributed to the PE unless it is established by the Revenue that the supplies were not at arm's length

¹³⁰ Ishikawajma Harima Heavy Industries Ltd Vs DIT (2007) 158 Taxman 259 (SC).

¹³¹ CIT Vs Hyundai Heavy Industries Co Ltd (2007) 291 ITR 482 (SC).

price. No such taxability can arise when the sales of material are directly billed to a third party.

- Once it is substantiated that the offshore supply of material is at arm's length and that the billing for offshore supply did not include provision of installation activities, no profits from offshore supply can be attributed to the "installation PE".
- Subsequent to the said decision, section 9 has been amended in 10 and 12 to significantly over rule the dictum of the later judgment.

7.4.5 Cessation of PE

The India-US Tax Treaty expressly provides that any income attributable to a PE during its existence is taxable in State of Source even if the payments are deferred until such time that the PE has ceased to exist. The material date for determination of accrual of income arising through the PE is the existence of the PE at the time when whatever decisively caused the profits to accrue, actually occurred.

7.5 Force of Attraction Rule

Business profits not attributable to a PE cannot be taxed in State of Source except under FOA rule in Art 7(1)(b) and (c). This rule applies if the following conditions are fulfilled:

- there is a PE in State S;
- the enterprise earns business profits in State of Source; and
- goods or merchandise are sold in State of Source and such goods, etc are of the same or similar kind as those sold through the PE, or, business activities are carried on in State of Source and such activities are of the same or similar kind as business activities carried on in State Source through the PE.

If the above conditions are fulfilled, the profits attributable to such sale of goods or the business activities would be taxable in State of Source. The sale, etc need not be conducted through the PE. It has been held that reference to sale of goods or merchandise in Art 7(1)(b) includes rendering of services also.

7.5.1 Purpose and philosophy

The FOA rule implies that when a foreign enterprise sets up a PE in State of Source, it brings itself within the fiscal jurisdiction of that State (State of Source) to such a degree that all profits that the enterprise derives from State of Source, whether through the PE or not, can be taxed by it (State of Source). It is the act of setting up a PE which triggers the taxability of direct transactions (conducted by the head office/ other branches of that enterprise, whether in the home country or elsewhere) in State of Source. Therefore, unless a PE is set up, the question of taxability of direct transactions conducted by the head office in State of Source will not arise. To illustrate, consider the case of a seller of jeeps in Source State through a showroom in that State. If the enterprise sells jeeps directly to some customers, i.e. not through the showroom, but direct exports from outside the State of Source to say a bulk customer, then the profits

arising on such bulk sale would also be attributed to the PE and would be treated as profits arising from the PE, under the FOA principle.

The scope of Art 7 extends only to those activities carried out by a foreign enterprise in State of Source, which are of the same or similar kind as those carried on through its PE in State of Source, and not all the activities of such an enterprise, as a FOA rule in its pure form, would have envisaged. The FOA rule in its pure form, or the "full force of attraction" principle, is not generally found in the current tax treaties. The rule underlying the modern treaties is an improvised and highly restricted FOA rule, popularly known as "limited force of attraction principle", which is a limited anti-avoidance rule. This restricted FOA rule in essence additionally expands taxation in State of Source by permitting States where non-residents maintain traditional PEs to tax another income that is attracted to the PE even though that income is not directly related to the PE. The FOA rule avoids administrative problems because it is not necessary to determine whether particular activities are related to the PE or the income involved is attributable to it.

7.5.2 Exemptions from FOA rule

The FOA rule applies to all activities satisfying the conditions in Art 7(1)(b)/(c) and the purpose or motive behind carrying out the activities outside the PE is not relevant. However, some jurisdictions have a differing view as follows:

- The FOA rule does not apply where the foreign enterprise is able to demonstrate that the sales or business activities were carried out in State of Source other than through the PE, for legitimate business reasons and not for obtaining treaty benefits.
- Sales by a foreign principal through independent agents in State of Source do not become taxable in State of Source under the FOA rule.

7.5.3 Same or similar

There may be situations where an installation PE may not be covered by the FOA rule even if the installation PE was selling goods which are same or similar to those sold directly by the foreign enterprise abroad. The reasons are as follows:

- Direct sales by a foreign enterprise in State of Source are covered by the FOA rule only when the PE is for the purpose of selling goods or merchandise.
- However, in the case of an installation PE, just because some goods are locally procured in State of Source and used in installation and commissioning, one cannot come to the conclusion that the foreign enterprise is engaged in selling same or similar goods as the installation PE. It may only be incidental to the main activity of installation and commissioning of a project that some local supplies may have to be made by an installation PE to the customer.

7.5.4 Article 7(1)(c) of the UN Model

The scope of Art 7(1)(c) is restricted to profits from any "other business activities" carried on in

State of Source. Hence, it cannot cover taxability of profit on sale of equipment by a turnkey contractor.

7.6 Controlled Foreign Corporation (CFC) rules

Article 7 contains rules for taxation and ascertainment of the profits of a foreign enterprise doing business in State of Source. Thus, on a plain reading, Art 7(1) does not restrict the right of State of Residence to tax its residents under its CFC regulations, even if such tax is computed with reference to the profits of an enterprise that is a resident of State S.

7.7 Article 7(2) of the UN Model

Article 7(2) contains the central directive on which the attribution of profits to a PE is to be done. It is a machinery provision, which provides the methodology for computation of profits of the PE.

7.7.1 Article 7(2) of the UN Model reads as follows:

"Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

Paraphrasing, Art 7(2) provides as follows:

- Profits to be attributed to PE should be computed after making the following assumptions:
 - The PE is a separate and distinct enterprise.
 - It is engaged in the "same or similar" activities as that of the foreign enterprise of which it is a PE.
 - It is operating under the same or similar conditions as that of the foreign enterprise of which it is a PE.
 - It was dealing wholly and independently with the foreign enterprise of which it is a PE
- Article 7(2) is subject to Art 7(3).

The Supreme Court¹³² has held that taxing corporates, on the basis of the concept of "economic nexus", is an important feature of attributing profits to a PE. Under Art 7(2), only such portion of the profits of a foreign enterprise is taxable in State of Source which has economic nexus with the PE. Article 7(2) lays down the view that the profits to be attributed to a PE are those which that PE would have made if, instead of dealing with its head office or the rest of the foreign enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Article 7(2) treats a PE as if it is an independent entity (profit centre) de hors the head

¹³² DIT Vs Morgan Stanley and Co Inc (2007) 292 ITR 416 (SC).

office and which deals with the head office at arm's length. It advocates the arm's length approach for attribution of profits to a PE. The profits to be taxed in State Source are, thus, not the real profits made by the foreign enterprise but hypothetical profits which the PE would have earned if it was wholly independent of the enterprise of which it is PE. The principles applicable for attribution of profits are also applicable for attribution of losses since the expression "profits" includes losses. The words "same or similar" mean comparable.

7.7.2 Article 7(2) and domestic law

On a plain reading Art 7(2) does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of profits that may be taxed in State of Source. It is not intended to prevent the application of the domestic law aimed at preventing abuse by artificially shifting the location of assets or risks outside State S.

7.7.3 Fiction only for Article

The fiction of treating a PE as a distinct and separate enterprise is limited to Art 7 which expressly provides so, and it does not imply that the PE must be treated as a separate enterprise for the purpose of the other articles or that the PE should necessarily be taken as an independent assessee in State S.

7.7.4 Taxability in State of Residence and State Source

The expression " ... there shall in each Contracting State be attributed to that permanent establishment the profits ... " in Art 7(2) makes it clear that the profits of the PE are taxable both in State and State S.

7.7.5 Dealings of PE with offices other than head office or other enterprises

Art 7(2) requires that a PE should be treated as dealing wholly independently with other PEs (and not only the head office) of the foreign enterprise. There is no express provision in Art 7(2) regarding dealings with other associated enterprises. The India-US Tax Treaty requires that the PE should be dealing wholly at arm's length with other enterprises controlling, controlled by or subject to the same common control as that enterprise and the India-Australia Tax Treaty contains a requirement that a PE should be dealing wholly independently with "other enterprise with which it deals".

7.7.6 FOA rule

Where, the FOA rule is applicable, and the profits other than those attributable directly to the PE are taxable in State of Source, such profits should also be determined in the same way as if they were attributable directly to the PE.

7.7.7 No accounts/exceptional cases

There may be circumstances in which:

- there are no accounts, nor can accounts be constructed; or

- the affairs of the PE and the head office are so interlinked that it is impossible to dissect them.
- In these situations, other methods could be adopted if such methods are appropriate and customary in order to arrive at the profits of a PE. To illustrate:
- profits of insurance companies may be ascertained as under: Premiums received from policyholders in State of Source * Appropriate factor.
- Where all patented goods produced by a foreign enterprise are sold through its PE, the PE's profits may be computed as follows: [Gross profit percentage of the foreign enterprise * Turnover of the PE (-) Expenses incurred by the PE (which are not considered while determining gross profits)].

7.7.8 Transfer of goods from PE to head office

Article 7 does not prevent application of the domestic laws of State of Source which may tax notional profits on internal transfers of goods by a PE to its head office even before a profit has been actually made by the head office. While applying the aforesaid principle, it is irrelevant that the transfer takes place during the course of business or at the time when the PE is being wound up.

7.7.9 Services

Where the main activity of a PE is to provide services to its head office which provide a real advantage to the foreign enterprise, State of Source may tax the PE on an arm's length basis.

7.7.10 Attribution of profits based on TP principles

Under Article 7, computation of profits of the PE (a separate entity) should be done based on the domestic laws of State S and by applying the arm's length principle of TP regulations in State S.

7.8. Attribution of profits to purchase activities

The UN Model does not contain Art 7(5) of the OECD Model. Since mere purchase of goods does not constitute a PE, no profits can be attributed in circumstances where the only activity carried on in State of Source is purchase of goods. However, if the PE, besides having a purchasing facility for the foreign enterprise, also has other businesses in State of Source, the profits attributable to the purchase function could also become taxable in State of Source in the absence of a specific exemption in the convention.

7.8.1 E-Commerce

The taxation of e-commerce transactions is a vexed issue. Some of the issues are discussed in the OECD TAG (Technical Advisory group) Report. Currently taxation of e-commerce is under the active consideration of the Base erosion and Profit Shifting (BEPS) project undertaken by the OECD under guidance from G 20, and it is expected that significant changes and rules of

determination of state of source and residence in such cases will be laid down in the near future.

7.8.2 Leasing of equipment/containers

The OECD has issued reports on taxation of income derived from leasing of equipment and containers. These reports explain the guidelines for profit attribution in case a foreign lessor is held to have a PE in State of Source in respect of the leasing activity.

7.8.3 Exceptional situations

Article 7(2) of certain Indian treaties provide that when determination of profits attributable to the PE presents exceptional difficulties then such profits may be estimated on a reasonable basis or an apportionment of profits. Before taking recourse to any other reasonable basis, there has to be certain diligence for determination of profits attributable to the PE on arm's length principle. The India-China Tax Treaty specifically permits attribution of profit on a deemed profit basis. As per the Technical Explanation to the India-USA Tax Treaty, this rule is to be applied only in unusual cases.

7.8.4 Attribution of profits to Agency PE

In case of a dependent agent PE, State of Source has the right to tax two different legal entities- the dependent agent (which may or may not be a resident of State of Source) and the dependent agent PE (which is a PE in State of Source of the non-resident principal). The profits of a foreign enterprise which are attributable to its dependent agent PE in State of Source are calculated using the same principles as used for other types of PEs.

A question that needs consideration is whether any profits remain to be attributed to the dependent agent PE after such deduction in respect of the arm's length reward to the dependent agent. In a decision by the Supreme Court¹³³ in the context of the domestic Indian tax law, it was held that profits were attributable to the non-resident principal, although remuneration was paid to the agent in India!¹³⁴. Subsequently, the Indian Revenue issued a Circular¹³⁵ clarifying that profits attributable to a non-resident's sales in India (where orders are secured through services of an Indian agent) are limited to the amount of profit attributable to the agent's services and if the agent's commission fully represents the profit attributable to his service, it would prima facie extinguish the assessment of the non-resident in India. However, subsequently, the said circular has been withdrawn by CBDT vide its circular dated 22 October 2009 (F.NO.500/135/2007-FTD-I).

In the context of BPOs, the CBDT in Circular 5 of 2004¹³⁵ has clarified as follows:

"Paragraph 3 only provides a rule applicable for the determination of the profits of the Permanent Establishment, while paragraph 2 requires that the profits so determined correspond to the profit that a separate and independent enterprise would have made. Hence, in determining the profits attributable to an IT enabled BPO unit constituting a Permanent Establishment, it will be

¹³³ Bikaner Textile Merchant Syndicate Ltd Vs CIT (1965) 58 ITR 169 (Raj).

¹³⁴ Circular No 23 dated 23rd July 1969.

¹³⁵ Dated 28th September 2004.

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necessary to determine the price of the services rendered by the Permanent Establishment to the Head office or by Head office to the Permanent Establishment on the basis of "arm's length principle". The "arm's length price" would have the same meaning as in the definition in Section 92F(ii) of the Income-tax Act. The arm's length price would have to be determined in accordance with the provisions of Section 92 to 92F of the Act."

On the other hand, the "Authorised OECD approach" recognises that there could be profits attributable to a dependent agent PE even after a deduction of an arm's length reward for the agent and any other interpretation may render Art 5(5) redundant

For example:

Consider an FMCG distributor by the name of Ger Co based in Germany. It manufactures FMCG and sells the same to its customers in India through its dependent agent, I Co, an Indian company. In consideration of the services rendered by I Co, Ger Co pays I Co a commission @ 20% on sales. Ger Co sells equipment in India after adding a mark up of 100% to the manufacturing cost. The handling costs of Ger Co for sourcing the merchandise is 30% on cost of purchases. Ger Co sells goods worth \$ 5 million in India. Expenses incurred by I Co, to earn the agency remuneration, is \$ 9,99,000. The profits taxable in India may be as follows:

A: Taxability of I Co

Commission earned by I Co: \$ 10,00,000 (20% of \$ 5 million)

Less Expenses of I Co: \$ 9,99,000

Profits Taxable in the hands of the I Co: \$ 1,000

B: Taxability of Ger Co

Sales in India: \$ 50,00,000

Less - Commission paid to I Co: \$ 10,00,000

Less - Cost of manufacture: \$ 25,00,000

Less - Handling charges: \$ 7,50,000

Net profit of Ger Co: \$ 7,50,000

The said sum of \$ 7,50,000 represents the earnings of Ger Co attributable to the dependent agent PE, on account of it (Ger Co) having a dependent agent in India. This income is taxable in the hands of Ger Co in India and the tax credit in respect of such taxability will be available to Ger Co in Germany. If, in this example, the income of the PE is only the remuneration earned by the agent on net basis, one will end up in a situation that while profits of Ger Co attributable to India operations will be \$ 7.50,000, the taxability of the profits in India will be confined to only \$ 1,000. However, the German Co. can claim an appropriate adjustment for the head office overheads and even a reasonable charge, on account of activities of the foreign enterprise carried on outside the host country (India), by treating the foreign enterprise as a fictionally separate entity.

The Supreme Court¹³⁶ also had to adjudicate whether profits could be attributed in the hands of the PE if MSAS was remunerated for its services at arm's length. While dealing with this issue, the Supreme Court held as follows:

- Once a transfer pricing analysis is undertaken, there is no further need to attribute profits to a PE.
- Insofar as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the foreign enterprise, nothing further could be left to be attributed to the PE.
- The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the foreign enterprise. In such a situation profits would be required to be attributed to the PE for those functions or risks that have not been considered.
- The entire exercise is to ascertain whether the service charges payable to the service provider (Indian group company) fully represents the value of the profits attributable to his service. In this connection, the revenue authorities have to examine whether the PE has obtained services from the multinational enterprise at lower than the arm's length.

In the case before the Supreme Court, a dependent agent PE was held not to exist. However, if the observations of the Supreme Court are regarded as being applicable to a dependent agent PE, then the tax liability of a foreign enterprise would be extinguished only if the agent was remunerated on an arm's length basis after taking into account all the risk-taking functions of the foreign enterprise (and not merely those of the dependent agent). It is not clear as to how the agent could be remunerated for all the risk-taking functions of the foreign enterprise, when such remuneration can only be a reward for his (agent's) own risk taking functions and not that of the foreign enterprise.

7.8.5 Article 7(2) in relation to Art 9

Both Art 7(2) and Art 9 require an application of the arm's length principle. However, both the articles apply in different scenarios. Art 9 applies only where there are **two** associated enterprises, one in each Contracting State, whereas, in the case of Art 7, there is only **one** enterprise which has a PE in State S.

7.9 Article 7(5) of the OECD Model

Article 7(5) of the OECD Model reads as follows:

"No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise."

Article 7(5) of the OECD Model deals with PEs which perform functions, other than purchasing activities, for the foreign enterprise. For instance, a PE may purchase raw materials for its head office and sell the manufactured goods. While profits may be attributable to the PE with respect

¹³⁶ DIT Vs Morgan Stanley and Co Inc (2007) 292 ITR 416 (SC).

to its sales activities, no profits are attributable with respect to purchasing activities. Correspondingly, any losses or expenses on account of the purchasing activities are not deductible in calculating the taxable profits of the PE.

Article 7(5) of the OECD Model is absent in the UN Model, and as such, under the UN model, even activities of mere purchase for resale outside India can lead to attribution of profit for that activity.

7.10 Article 7(3) of the UN Model

Article 7(3) of the UN Model reads as follows:

"In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices."

Paraphrasing Art 7(3) of the UN Model:

(i) Expenses

- a. All expenses incurred for the purposes of the business of the PE shall be allowed as a deduction, in determining profits of a PE.
- b. Such expenses include executive and general administrative expenses.
- c. Such expenses could be incurred within or outside the State in which the PE is situated (State of Source).
- d. In case of a banking enterprise, such expenses would include interest on moneys lent by the head office or other offices to the PE.
- e. Such expenses would include reimbursement by the PE of actual expenses incurred by the head office or other offices.
- f. Subject to d. and e. above, no deduction shall be allowed in respect of amounts paid by

the PE to the head office or other offices by way of:

- royalties, fees or similar payments in return for use of patents and use of other rights;
- commission for specific services performed or management;
- interest on moneys lent to the PE (in case of non-banking enterprise).

(ii) Receipts

- a. In case of a banking enterprise, receipts of PE would include interest on moneys lent by the PE to the head office or other offices.
- b. Receipts of the business shall include reimbursement to a PE by the head office or other offices.
- c. Subject to b. above, receipts of PE would not include amounts paid to the PE by the head office or other offices by way of:
 - royalties, fees or similar payments in return for use of patents and use of other rights;
 - commission for specific services performed or management;
 - interest on moneys lent to the head office or other offices (in case of non-banking enterprise).

The principle behind the second and third sentence of Art 7(3) of the UN Model is that payments by a PE to its head office (or other PEs) or receipts from such offices by the PE are only in the nature of mutual adjustments between various branches of the same person and are not relevant in computing the profits attributable to the PE

A PE can deduct interest, royalties and other expenses incurred by the head office specifically on behalf of the PE. Where the payment is made by the PE to the head office by way of reimbursement of actual expenses, it has to be deducted because it really goes out of the enterprise. Where obtainment of technology by the head office and its provision to the PE are not causally interconnected, payments by the PE to its head office for the technology supplied by the head office to the PE are not reimbursements and consequently, not deductible by PE. This may happen when the head office, as a part of its general activities, may acquire, modify, refine or update technology or create new technology on its own and the PE is not concerned there with.

The UN Commentary observes that "The OECD Commentary on Article 7, paragraph 3, is relevant" and then reproduces the OECD Commentary. However, considering the differences in the language between the UN Model and the OECD Model, it is difficult to comprehend how all the principles of the OECD Commentary could be applicable so far as the UN Model is concerned. One will need to read the commentary as being relevant, *mutatis mutandis*.

7.11 Article 7(4) of the UN Model

Article 7(4) of the UN Model reads as follows:

"In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article."

Paraphrasing, profits can be attributed to the PE by apportionment of the total profits of the enterprise to its various parts, provided:

- it is customary in State of Source to determine the profits in such a manner;
- the method of apportionment adopted is such that the result is in accordance with the principles in Art 7.

Article 7(4) determines the profits to be attributed to a PE by apportioning the total profits of the enterprise on the basis of various formulae. It is a machinery provision and not a charging provision. The underlying principle of Art 7(4) is that all parts of an enterprise contribute to its profitability and such contribution can be determined on the basis of the adopted criteria.

Article 7(4) prescribes a method different from that in Art 7(2), since, unlike Art 7(2), it does not contemplate an attribution of profits on a separate enterprise footing. It is not as scientific a method as under Art 7(2). Hence, Art 7(4) might produce a result which is different from that by applying of Art 7(2) and should be used only where it has been customarily used in the past and accepted both by the tax authorities and taxpayers as being satisfactory.

7.11.1 Criteria for apportionment

The criteria commonly used for apportionment, is discussed and illustrated in Model Commentaries.

7.11.2 Consistency with principles of Article 7

The general object of any method under Art 7(4) is to determine taxable profits of a PE at an amount fairly in accordance with the principles contained in Art 7, that is, Art 7(4) should approximate, as much as possible, to the amount that would be determined on a separate accounts basis.

7.11.3 Manner of determination of profits

The profits to be apportioned to a PE should be the profits as computed under the laws of each particular country. For Indian purposes, a reference could be made to Rule 10 of the Income-tax Rules, 1962.

7.12 Article 7(5) of the UN Model

Article 7(5) of the UN Model reads as follows:

"For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary." Article 7(5) is also a machinery provision and not a charging provision.

7.12.1 Use of different methods

As provided in Art 7(5), in the absence of good and significant reasons, a method of allocation once used should not be changed merely because in a particular year, application of some other method yields more favourable results.

7.13 Article 7(6) of the UN Model

Article 7(6) of the UN Model reads as follows:

"Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article."

Article 7(6) provides that the articles dealing with specific categories of income (e.g., dividends, interest, royalties, etc.) override the provisions of Art 7, unless such articles state otherwise like in Art 10(4), 11(4), 12(4), etc.). Even otherwise, it is a well-settled principle that a specific provision overrides a general one. Hence, dividends, interest, royalties, etc. are taxable under Art 10 to 12 even if they are earned in the course of business. Thus, Art 7 applies to industrial and commercial income which does not belong to categories of income covered by the special articles.

The word "permanent establishment" is not attached to the profits which are included in other articles dealing with passive income like dividends, interest and royalties, and the presence/absence of PE cannot create or vitiate a ground for taxation under those articles except as specifically mentioned in those articles.

7.14 Judicial precedents

- Profit attribution to a PE should be based on a transfer pricing analysis that adequately reflects the functions performed, assets employed and risks assumed i.e. (FAR) analysis - Morgan Stanley & Co [2007](292 ITR 416)(SC), Rolls Royce Singapore (P) Ltd [2012](347 ITR 192)(Del HC), E-funds IT Solutions Inc (2017) 399 ITR 34 (SC), Sabre Asia Pacific Pte. Ltd. (2018) 91 taxmann.com 434 (Mum ITAT).
- Attribution of profits to PE in India has to be in line with extent of activities of PE in India and depends upon role played by PE in overall generation of income - Nipro Asia Pte Ltd [2017](79 taxmann.com 154)(Del ITAT)

Ad hoc attribution:-

- Taxability of trading profits where sale is concluded in India -- 10% of supply – Annamalis Timber 41 ITR 781 (Madras HC)

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- Taxability of offshore supplies where PE played some role - 20% of global profits – Motorola Inc : 96 TTJ 1 (Delhi ITAT, SB)
- Taxability of CRS activities where agency PE played marketing activities - 15% of the total revenues - Galileo International Inc : 114 TTJ 289 (Del. ITAT)
- Taxability of back office operations where PE looks after operations and marketing activities of overseas affiliates - Global adjusted profits x India assets/Global assets : eFunds 42 SOT 165 (Delhi ITAT)

Force of attraction:

Roxon OY (2007) 106 ITD 489 (Mum ITAT):-

- Article 7 of the India Finland DTAA based on the UN Model Convention which envisages
 - (i) Direct sales by an enterprise covered by “force of attraction rule” only when enterprise has a PE for selling goods and direct sales by enterprise is same or similar kind of goods.
 - (ii) Installation PE thus to be excluded – ab initio
- Profits earned on supply of equipment cannot be said to be attributable to PE as installation PE comes into existence after supply of equipment. Hence question of taxing such profit does not arise unless PE was set-up
- Even otherwise, no part of equipment supply profit can be attributed to PE if supply is at arm's length.

Clifford Chance (2013)154 TTJ 537 (Mum ITAT SB):-

- Directly attributable to PE – explained in Article 7(2) - PE to be treated as separate and distinct enterprise
- Profits indirectly attributable to PE – Defined in Article 7(3) – Active part in negotiating, concluding or fulfilling contracts – Article 7(3) is unambiguous
- Meaning given in UN convention is materially different from provisions of Article 7(1) of India-UK treaty - no need to rely on meaning given under UN Convention
- Profits apportioned to activities of other parts of enterprise cannot be treated as profits indirectly attributable to the PE

Husco International Inc. v. ACIT (IT), Pune [2021] 133 taxmann.com 196 (Pune - Trib.)

Assessee, a US based company, purchased different software products and transferred some of them to Indian entity at cost. There was only a limited access to software products without any right to copy same. Hence it could not have transferred anything more than that to its entities globally including India. It was held that amount received from Indian entity on transfer of copyrighted articles was not royalty income in hands of assessee within meaning of article 12(3) of DTAA between India and USA. Also in case of purchase of licenses of different software, in absence of PE in India, software license fee would not be taxable as business profits.

Sumitomo Corporation v. DCIT [2021] 127 taxmann.com 638 (Delhi - Trib.)

Assessee company supplied equipments and spare parts to Indian company from outside India. The assessee did not undertake any activity of installation and commissioning of such equipments supplied in India. Also supply of equipments and spare parts were not made in India. Assessee had no PE in India as per Article 5 of DTAA. Hence it was held that profit from offshore supply of equipment was not taxable in India.

Ajay Kumar Singh Gaur v. ITO [2021] 127 taxmann.com 630 (Agra - Trib.)

Commissions were paid outside India to assessee's agent for procuring orders for assessee. Assessee received income in India after deduction of commission by buyer outside of India. Since income was not received or paid inside India, assessee was held to be not liable to deduct TDS in India.

Watanmal Boolchand & Co. Ltd. v. ADIT [2021] 127 taxmann.com 361 (Mad)

Petitioner-company was incorporated in Hong Kong. It entered into a trade service agreement with its AE, WIPL, incorporated in India. There was a survey conducted at the premises of WIPL. On the basis of documents collected during survey, Assessing Officer held that there was business connection as WIPL was carrying on core/primary business activities for petitioner. Also pursuant to trade service agreement, it was held that the petitioner had engaged WIPL as its authorized agent to negotiate and conclude all purchase and sale contracts of branded food products. Based on the evidences available with revenue and modus operandi of petitioner, presence of petitioner was established in India through its business connection with WIPL and section 9(1)(i) was invoked. Notice issued under section 148 could not be quashed.

7.15 OECD's additional guidance on profit attribution to PE pursuant to BEPS Action Plan 7

To prevent the use of certain common tax avoidance strategies used to circumvent the existing PE definition, BEPS action plan 7 inter alia provides changes to the rules on PE created by dependent agents. Changes are also proposed in the specific activity exemptions for a PE, which are to be implemented through the MLI. The Finance Act, 2018 recently amended the domestic law to align the agency PE definition with BEPS action plan 7 and MLI. These changes in the PE rules mandated additional guidance on how the provisions of Article 7 would apply to such resulting PEs. Accordingly, in March 2018, the OECD has issued a report providing additional guidance on attribution of profits to PE in the circumstances addressed by the BEPS action plan 7 report. The additional guidance covers specific examples dealing with:-

- Warehousing, delivery, merchandising and information collection activities
- Commissionaire structure (related intermediary)
- Sale of advertising on a website (related intermediary)
- Procurement of goods (related intermediary)

In the context of an agency PE, the report states that when an agency PE is deemed to exist due to the activities of an intermediary, those activities are relevant to two taxpayers in the host

country: the intermediary (which may be a resident of the host country) and the PE (which is a PE of a non-resident enterprise). The arm's length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7.

In the examples dealing with agency PE, broadly speaking the profits attributable to the PE are determined by deducting from the sale consideration charged to the customer, the following amounts: (i) arm's length pricing of internal dealing of 'purchase' by the PE from the head office; (ii) remuneration paid to intermediary; and (iii) other expenses for the purpose of the PE.

The report also states that it should be noted that the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary.

8. Article 8 – Shipping, inland waterways transport and air transport

8.1 Background

The income earned by ships and aircrafts could be taxed in the country in which the said income is earned under the 'source rule' and also in the country of residence of the tax payer. This often leads to double taxation.

In order to overcome such a situation, Double Taxation Avoidance Agreements ('DTAA') allocate taxing rights between countries for taxation of income arising from shipping and air transport operations. Article 8 of the OECD and UN Model Conventions deal with taxation of income earned from shipping or airline business.

The operation of ships and aircrafts cover several routes, and if every country taxed a portion of the profits of a shipping company or an airline as per the provisions of Article 7 which deals with business profits, it could result in taxation of fragmented profit in several jurisdictions. Thus, on account of the distinct nature of activities carried out by shipping and airline enterprises it was necessary for a mechanism to expressly specify the country that shall have a right to tax their income along with its nature, scope and extent.

Therefore, provisions of Article 8 are beneficial as they provide for exemption from taxability in the source country.

8.2 Article 8 of OECD and UN Model Conventions

Article 8 of the OECD Model Convention is reproduced below:

1. *Profits from the operation of ships or aircrafts in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
2. *Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*

3. *If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.*
4. *The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.*

Article 8 of the UN Model Convention contains two alternatives for allocation of taxation rights on profits from shipping business. The text of the Article 8 of the UN Model Convention is reproduced below:

Article 8 (alternative A)

1. *Profits from the operation of ships or aircrafts in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
2. *Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
3. *If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbor of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.*
4. *The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.*

Article 8 (alternative B)

1. *Profits from the operation of aircrafts in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
2. *Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.)*
3. *Profits from the operation of boats engaged in inland waterways transport shall be taxable*

only in the Contracting State in which the place of effective management of the enterprise is situated.

4. *If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbor of the ship or boat is situated, or if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.*
5. *The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.*

On a comparison of the two model conventions, it can be seen that the Alternative A under the UN Model Convention resembles the OECD Model Convention while the Alternative B deviates from the OECD Model Convention.

Under the OECD Model Convention and Alternative A of the UN Model Convention, profits from shipping or airline business are sought to be taxed only in the country where the “Place of effective management” (POEM) is situated, The UN Model Convention provides an alternative only for taxing profits from shipping business. Alternative B provides for taxation in the other Country, in case the activities are “more than casual” in that Country on the basis of allocation of overall profits.

The DTAA's entered into by India either give taxing rights to the country of residence of the enterprise or the country where POEM is situated, thus following Alternative A of the UN Model Convention/OECD Model Convention. However, our discussion in this study material is related only to the said alternative.

Further, Article 8 of DTAA between India and Greece is unique as well as interesting as it does not give taxing right to the state where enterprise has POEM but it provides taxing rights to both the countries. The extract of said article is reproduced below:

“1. When a resident of Greece, operating ships, derives profits from India through such operations carried on in India, such profits may be taxed in Greece as well as in India; but the tax so charged in India shall be reduced by an amount equal to 50 per cent thereof, and the reduced amount of Indian tax payable on the profits shall be allowed as a credit against Greek tax charged in respect of such income. The credit aforesaid shall not exceed the Greek tax charged in respect of such income?”

8.3 Scope of Article 8

On a plain reading of Article 8, it can be seen that it is applicable to the profits derived from **operation of ships or aircraft in international traffic** or **operation of boats engaged in inland waterways transport** by an enterprise which is resident of a contracting state.

Such profits derived by the enterprise are taxable only in the country in which the **place of effective management** of the enterprise is situated. Some countries may prefer to confer taxing

rights on the country of residence instead of place of effective management.

Most Indian DTAA's, for example, with Australia, Belgium, Cyprus, Malta, France, Singapore, South Africa, US, UK, provide that such profits are taxable only in the country in which the enterprise is resident. While DTAA's with others such as Germany, Netherlands, Mauritius, Brazil, etc. give taxing rights to the country in which place of effective management of the enterprise is situated.

As per Article 8 of the OECD Model Convention/ Alternative A of the UN Model convention, an enterprise shall be taxable in the country in which its POEM is situated if the following conditions are satisfied:

- There should be an enterprise which is resident of one of the contracting states;
- deriving profits from the business of 'operation of ships or aircraft';
- in 'international traffic'; or
- deriving profits from the 'operation of boats engaged in inland waterways transport'

8.4 Applicability of Article 8

Being a special provision applicable to shipping, inland waterways transport and air transport, Article 8 takes precedence over Article 7 which applies to all other business income. However, Article 8 applies only where profits from the operation of ships or aircrafts in international traffic or from operation of boats engaged in inland waterways transport are involved even if such profits could be attributed to the permanent establishment under Article 7.

Thus, in a case where the enterprise is not only engaged in shipping, inland waterways transport or air transport, but also in other business activities as well, Article 8 will be applicable only to the profits derived from shipping, inland waterways transport or air transport. Income from the other business activities shall be governed by the permanent establishment principle and covered by Article 7.

If the permanent establishment's activities in the country are confined to the operation of ships or aircrafts, Article 8 should be applied. If, conversely, the permanent establishment is exclusively carrying out activities in the country which are not in relation to operation of ships or aircrafts, Article 7 would apply whether or not the enterprise carries on operation of ships or aircrafts in other countries.

Income derived from the operation of ships or aircraft 'other than in international traffic' comes within the scope of Article 7 if it constitutes business profits of the enterprise.

Article 8 applies when the enterprise's place of effective management is situated in either of the contracting states. If the POEM is situated in a third state while the enterprise is a resident of neither contracting state, Article 8 will become inapplicable, as the general condition laid down in Article 1¹³⁷ regarding applicability of a DTAA is not met. In such an event, both contracting

¹³⁷Article 1 – Persons Covered – DTAA shall apply to persons who are residents of one or both of the contracting states

states are free to tax the profits in accordance with their domestic laws and to do so by both attaching taxation to the POEM and to the existence of a permanent establishment or merely to the fact that the enterprise takes on passengers or cargo within the domestic territory¹³⁸.

Therefore Article 7 and not Article 8 may need to be applied in the following cases:

1. Profits are derived from activities other than that of operation of ships or aircraft or from operation of boats engaged in inland waterways transport.
2. In case a permanent establishment is engaged in other businesses in the country along with engaging in operation of ships or aircrafts in international traffic or from operation of boats engaged in inland waterways transport.
3. Profits are derived from business of the operation of ships or aircraft other than in international traffic.
4. The POEM of the enterprise is situated in a country other than the country of residence or the country of source of income from shipping, inland waterways transport and air transport.

Hence it is important to understand the scope of income earned by a shipping or airline company that could come within the ambit of Article 8 and the country in which such income could be brought to be taxed. Further, it would be important to discuss the meaning of the terms 'operation of ships or aircraft', 'international traffic', 'POEM' and 'operation of boats engaged in inland waterways transport'.

8.5 Meaning of operation of ships or aircraft

The profits covered under the scope of Article 8 consist of profits earned by the enterprise from the 'operation of ships or aircraft'.

In a few DTAA's entered into by India, what could constitute income from 'operation of ships or aircraft' has been defined (example, DTAA's with Brazil, Belgium, USA, China, Mauritius, Singapore, etc.). Where as in other DTAA's with Germany, Japan, Netherlands, etc. the term has not been defined.

Where the term has been defined in the DTAA, it would need to be construed in the manner provided therein. However, where the term has not been defined, reference can be made to the domestic law or the commentaries on international law.

Generally operation of ships or aircraft would mean the transportation of passengers or cargo by ships or aircrafts whether owned, leased or otherwise at the disposal of the entity and the activities related to such transportation and any income generated from such transportation shall come within the ambit of Article 8.

In addition to profits from transportation of passengers or cargo, shipping or airline companies invariably carry on a large variety of activities which facilitate or support their operations. Article

¹³⁸Klaus Vogel on Double Taxation Conventions, Third Edition, Pg. 483

8(1) covers profits from activities which are directly connected with such operations as well as profits from activities which may not be directly connected with the operation of ships or aircrafts, but are ancillary to such operation.

The crucial test is to determine whether a connection, either direct or ancillary, exists between the profits earned by the enterprise and the operation of ships or aircraft in international traffic.

Reference in this regard can be made to the OECD Commentary¹³⁹ on Article 8 which states that any activity carried on by the enterprise primarily in connection with the transportation of passengers or cargo by ships or aircrafts that it operates in international traffic should be considered as directly connected with such transportation. Further, activities which make a minor contribution and are so closely related to operation of ships or aircraft that they should not be regarded as a separate business or source of income should be considered to be ancillary to the operations of ships or aircrafts in international traffic.

Examples of profits from ‘operation of ships or aircraft’ under a DTAA

Some examples¹⁴⁰ that provide an understanding of what may be regarded as profits from activities carried on by enterprises engaged in operation of ships or aircraft are discussed below:

- (i) Profits obtained by an enterprise on account of leasing of ships or aircrafts on time charter¹⁴¹ or voyage charter¹⁴² along with entire crew and supplies would be considered as profits from carriage of passengers and cargo.

However, profits from bareboat charter¹⁴³ could be characterized as business profits (under Article 7) or as royalty (if use of equipment is included within the definition of royalty under Article 12) except where leasing of ship or aircraft on a bareboat charter is ancillary to the activity of an enterprise engaged in operation of ships in international traffic. Determination of whether a bareboat charter is an ancillary activity would depend upon its frequency and economic significance to the enterprise.

For example, if an enterprise operating a large fleet of ships leases one or the other of them on bareboat charter basis, may be regarded as ancillary even for lengthy charter periods. Whereas an enterprise owning a single ship leases it out on bareboat basis for lengthy period of time cannot be regarded as ancillary. In the latter case, profits could be

¹³⁹Para 4.1 and 4.2

¹⁴⁰OECD Commentary on Article 8

¹⁴¹A time charter is a contract for leasing between the owner and the lessee wherein the owner or the lessor provides a fully equipped or manned ship or aircraft at the disposal of the lessee for a specific period of time in consideration of hire charges. The owner is responsible for providing the crew and bearing the operating costs while all voyage related costs during the period of lease are paid by the charterer.

¹⁴²Under a voyage charter agreement, the owner agrees to lease to the charterer for a particular voyage. The cost paid for such a lease includes costs like fuel, loading and unloading of the cargo etc. The owner supplies the charterer with the ship or aircraft and sometimes the crew for a voyage to a designated port.

¹⁴³A bareboat charter is an arrangement for the chartering or hiring, whereby no crew or provisions are included as part of the agreement; instead, the people who rent the vessel from the owner are responsible for taking care of such things.

taxable under Article 7 or Article 12, as the case maybe.

- (ii) Profits derived by an enterprise engaged in operating feeder vessels¹⁴⁴.
- (iii) Slot chartering or code sharing agreements are a regular feature in the shipping and airline industry. Under a Slot charter agreement, the owner or charterer of the ship agrees to place a certain number of container slots at the charterer's disposal. Similarly, under a code sharing agreement two or more airlines share the same flight in the sense that each airline publishes and markets the flight under its own airline and flight number as part of its published timetable or schedule.

Profits from carriage of goods or passengers under slot charter or code sharing arrangements can be regarded as directly connected with operation of ships or aircraft. However, where slot chartering is the only activity carried on by the charterer, such profits may not be regarded as profits from operation of ships.

- (iv) Charges for inland transportation commonly referred to as inland haulage charges (IHC) are often collected by shipping companies for activities undertaken to have passengers or cargo picked up in the country where transport commences or to be transported in the country of destination by any mode of inland transportation in course of their international shipping operations. The transportation may be by road or rail.

For example, where a shipping company undertakes to pick up cargo from New Delhi which is to be loaded at its ship in Mumbai to be transported to Dubai.

In such a case, the profit derived by the shipping company from organizing such transportation being ancillary to the main transportation may be regarded as profits from operation of ships. However, profits of any other enterprise which only provides such inland transportation to the aforesaid entity should not be included.

- (v) Profits from sale of tickets by a foreign enterprise on behalf of other enterprises if such sale is directly connected with or is ancillary to its own operations of ships or aircrafts in the international traffic.

For example, if a shipping company PQR is operating an international cruise between places X and Y in two countries, the sale of tickets by PQR for domestic travel to X or from Y on another company's ship is covered under Article 8.

- (vi) Income from publishing advertisements in magazines provided on ships or aircrafts operated in international traffic or placing advertisements at ticket booking offices would get covered under the ambit of Article 8 as the activity of advertising can be regarded as ancillary to operation of ships or aircrafts.
- (vii) Profits derived from the lease of containers if it is either directly connected or incidental

¹⁴⁴Feeder vessels or feeder ships are ships that collect shipping containers from different ports and transport them to central container terminals where they are loaded to the Main Line Operator (MLO) vessel. In that way the smaller vessels feed the big liners, which carry thousands of containers. FVOs issue the bill of lading to the MLO for the voyage between origin / destination ports and hub ports and earn income from them in the form of freight.

to international operation of ships or aircrafts.

- (viii) Profits from short term storage (e.g. where the enterprise charges a customer for keeping a loaded container in a warehouse pending delivery) or detention charges for the late return of such containers.
- (ix) Income from provision of goods (e.g. spare parts) and services by engineers, ground and equipment maintenance staff, cargo handlers, catering staff, etc. by a shipping or airline company where such supply of goods and services is directly connected with or incidental to its business of operation of ships or aircrafts in international traffic.
- (x) Interest on funds connected with operation of ships or aircraft in international traffic, e.g. where funds are required under law to be deposited as security for carrying on the business, shall be covered under Article 8.

Where the above activities constitute the primary and main activities of the enterprise and are not ancillary or complementary to carriage of goods or passengers by ships or aircraft, benefit of Article 8 may not be available.

Contrary to the above, some of the incomes that are typically not covered by Article 8 are:

- (i) Profits derived by a shipbuilding yard operated in one country by a shipping enterprise having its POEM in another country.
- (ii) Investment income of shipping or air transport companies (e.g. income from shares, etc.), unless the investment generating the income is an integral part of the business of operation of ships or aircrafts in international traffic.
- (iii) Interest or income generated from investment of surplus profits.
- (iv) Profits derived by a Non Vessel Operating Common Carrier¹⁴⁵ (NVOCC)
- (v) Profits from operation of vessels engaged in fishing, dredging or hauling activities in international waters, unless the DTAA specifically include such profits
- (vi) India does not agree to the view that income from trading of emission permits and credits are covered in Article 8

Thus in summary, carrying on of transportation by the assessee himself as owner, lessee or charterer is an essential condition for claiming benefit under Article 8. Also, what could constitute profits from operation of ships or aircrafts that could get covered by Article 8 would depend upon connection of the profit generating activity with that of transportation of goods or passengers.

8.6 Meaning of 'international traffic'

For claiming relief under Article 8, the shipping and airline operations need to be in the course of 'international traffic'. The definition of 'international traffic' as per the UN and OECD Model

¹⁴⁵NVOCC is a shipment consolidator or freight forwarder who does not own any vessel, but functions as a carrier of goods using container slots on vessels of other operators. The NVOCC assume responsibility for the shipments and issue its own bills of lading for the shipments to the shippers.

Convention is identical. Article 3(1)(e) of these conventions define 'international traffic' as:

“any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State.”

Where the ship or aircraft is operated solely on voyages within the source country, the ship or aircraft cannot be said to be operating in international traffic. The crucial expression to determine whether a voyage is in international traffic or in coastal traffic is the term 'solely'. For the purpose of qualifying a voyage coastal traffic, the voyage is must begin, end and take place within the coastal waters of a particular State. If the voyage does not qualify as being in coastal traffic, it can be regarded as international traffic.

If any ship is operated by a resident of a contracting state in another contracting state, it shall be considered operated in international traffic even after it is operated between two places in the other state by chance or as part of a longer voyage between two countries.

For example, as a part of same voyage, transportation of cargo from Germany to Mumbai and then from Mumbai to Chennai would be regarded as transport in “international traffic”.

Profits from the operation of ships solely in coastal traffic of a country shall be taxable under Article 7 of the DTAA by applying the permanent establishment principle, whereas Article 8 shall apply where such operation is in the course of international traffic.

For example, an enterprise which has its POEM in Mauritius sells tickets for a passage that is confined wholly within India through an agent in India, Article 8 does not permit Mauritius to tax profits of such voyage. India can tax profits of such voyage under Article 7 since the agent would constitute a permanent establishment in India and because the operations are confined solely to places in India.

8.7 Place of Effective Management (POEM)

The term 'POEM' has not been defined in the UN or OECD Model Convention. However, the OECD Model Commentary on Article 4 states that POEM refers to a place where the key management and commercial decisions that are necessary for conduct of entity's business as a whole are in substance made. It further provides that an entity may have more than one 'place of management' but it can have only one POEM at any one time.

Further, the UN Model Commentary on Article 4 refers to following circumstances to be taken into account for establishing POEM:

- Place where company is actually managed and controlled;
- Place where decision making at the highest level on important policies essential for management of the company takes place;
- Place that plays a leading part in the management of a company from an economic and functional point of view;

- Place where most important accounting books are kept.

The definition of place of effective management in the Indian domestic law¹⁴⁶ is similar to that stated in the OECD Model commentary. Further vide Circulars No. 6 of 2017 dated 24 January 2017, No. 8/2017 dated 23 February 2017 and No. 25/2017 dated 23 October 2017, the CBDT has issued guiding principles for determination of POEM of a company.

Determination of place of effective management is a fact based exercise. Reference for more detailed discussion in this regard can be made to the study paper on Article 4¹⁴⁷.

In DTAA's giving rights of taxing such profits to the country in which POEM is situated, it is important to first determine residency of the enterprise claiming taxability in the country of POEM as per Article 8 of the DTAA. Where the POEM is in a country other than the Contracting States, the exemption from taxation in the source country under Article 8 of that DTAA may not be available. In such a case, both the country of residence and the country of source could tax such profits.

This is due to the fact that any DTAA is applicable only to residents of the countries who have entered into the DTAA, commonly known as 'Contracting States'.

Therefore, to claim benefit of a DTAA, the shipping or air transport enterprise would need to be resident in one of the contracting states. Further, the DTAA cannot give taxing rights to a third state where the POEM of the enterprise is situated. For determining who could be regarded as residents, reference can be made to the study paper on Article 4.

The DTAA between the source country and the country where POEM is situated maybe applied, provided the enterprise is also deemed resident of the country in which POEM is situated by virtue of the domestic laws of that country, i.e. the enterprise has dual residency – in the country where it is incorporated and in the country where POEM is situated.

Article 8(3) of the OECD Model Convention also provides that where the POEM of an enterprise is aboard a ship or a boat, income from operation of ships will be taxable in the country where the home harbor of the ship or boat is situated. In a case where home harbor of ship or boat cannot be determined, right to tax has been given to the country of which the operator of the ship or boat is a resident.

8.8 Profits from the operation of boats engaged in inland waterways transport

Article 8(2) of the UN / OECD Model Convention provides that profits from the operation of boats engaged in inland waterways transport shall be taxable only in the country in which the POEM of the entity is situated.

The term 'inland waterways' has not been defined in either of the Model Conventions. However,

¹⁴⁶As per Explanation to section 6(3) of the Income Tax Act, 1961, inserted vide Finance Act, 2016 w.e.f. 1 April 2017

¹⁴⁷Article 4 of the Model Convention covers the meaning of the term resident

the OECD Model Commentary clarifies that the object of this paragraph is to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic.

Contrary to the arrangement for ships or aircraft, the rule on boats engaged in inland waterways transport is not restricted to international traffic but extends to transportation services between two points within one state by an enterprise of the other State¹⁴⁸.

In other words, the country of POEM is entitled to tax not only profits from operation of boats in inland waterways transport between two or more countries but also profits derived from such transportation carried out solely between points in the other country.

Principles for determining what could constitute profits from operation of ships as detailed above in Para 5 could be used as guidance (with necessary adaptations) in determining which profits may be considered to be derived from inland waterways transport.

This paragraph of the OECD/UN Model Convention may not be relevant in the Indian context as generally Indian DTAA's do not provide for taxability of profits from the operation of boats engaged in inland waterways transport.

8.9 Participation in a pool, a joint business or an international operating agency

As per the provisions of Article 8(4), profits earned from participation in a pool, a joint business or an international operating agency by an enterprise engaged in operation of ships or aircrafts are also eligible to be taxed in the country in which POEM of the enterprise is situated¹⁴⁹.

The terms 'pool', 'joint business' and 'international operating agency' are not defined under the OECD and UN Model Conventions. The terms cover all forms of co-operation in operation of ships or aircraft.

In common parlance a pool means a co-operation on an international level in shipping or air transport.

Entities engaged in international transport may enter into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircrafts in other countries.

There can be various forms of international co-operation by shipping or air transport enterprises, which may take place in the technological as well as commercial fields. Such co-operation could

¹⁴⁸Klaus Vogel on Double Taxation Conventions, Third Edition, Pg. 488

¹⁴⁹ In India context, Article 8 of DTAA between India and Oman specially provides that '*Profits derived by an enterprise of a Contracting State from the operation of aircraft in international traffic shall be taxable only in that Contracting State*'. Further, '*the provisions of paragraph 1 will also apply in case of shall also apply to profits from the participation in a pool, a joint business or an international operating agency*'.

range from pooling of supplies of spare parts at airports, alternating operations of certain flights routes, providing maintenance services by ground staff at certain airports, sharing aircraft parts, aircraft tooling, ground handling equipment and manpower all over the world, etc.

For e.g. where under a technical pool agreement, an airline company agrees to provide spare parts or maintenance services to other aircrafts at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircrafts in international traffic.

Therefore, where an airline being a participating member of an international airlines organization such as the International Airlines Technical Pool (IATP) earns profit from rendering and availing services to and from other airlines, it can claim taxability in the place where POEM is situated.

8.10 Case Studies

8.10.1 Scope of Article 8

RST Airline is a company engaged in the business of operation of aircraft, and is a resident of Germany. The POEM of RST Airline is also Germany. It operates a hotel in India which forms a permanent establishment of RST Airline in India. Let us examine the taxability of RST Airline under various scenarios as under:

- (a) The hotel of RST Airline in India only accommodates passengers in transit on the international flight of RST Airline. The cost of providing the accommodation service is included in the price of the air ticket.

Answer: RST Airline is engaged in the business of operation of aircraft in international traffic. As per provisions of Article 8(1) of the India-Germany DTAA, profits from operation of aircraft will be taxable in Germany, being the country in which POEM is situated. As per Article 7 of the DTAA, where profits of a German company are attributable to a permanent establishment in India, such profits may be taxable in India.

However, in the instant case the hotel business is carried out only for the purpose of providing accommodation to the passengers of international flights of RST Airline. Hence the hotel can be regarded as a kind of waiting room. Since the profits from the hotel business are ancillary to operation of aircraft in international traffic, such profits shall not be taxable in India despite the existence of a permanent establishment in India. Article 7 of the DTAA cannot be applied to said profits. The income from hotel business will also be taxable in Germany as per Article 8 of the DTAA.

- (b) The hotel of RST Airline in India accommodates guests other than its passengers and hence generates income separate from the airline business.

Answer: Since the hotel business in India is not connected with RST's airline business and it cannot be considered as operation of aircraft in international traffic, provisions of Article 8 of the DTAA cannot apply.

Further, since the hotel constitutes a permanent establishment of RST Airline in India, the profits attributable to such business would be taxable in India as per the provisions of Article 7 of the DTAA.

- (c) The hotel of RST Airline caters to the passengers of its international flight in addition to other guests. The passengers are not separately charged for the use of the hotel but charges are included in the cost of ticket. Whereas other guests are separately charged.

Answer: As discussed in b. above, the profits of the hotel business to the extent derived from guests other than the passengers on the international flights of RST Airline would be taxable in India as per provisions of Article 7 applying the permanent establishment principle. The income generated from passengers will be exempt from tax in India (see discussion in a. above).

Further, the expenditure incurred by the hotel for performing services for passengers of RST Airline cannot be claimed as deductible in India while computing the profits attributable to the Indian permanent establishment.

Profits from operation of ships or aircraft

An airline company AIR Airline operates a bus service for the passengers of its international flights. The bus service connects the town with the airport, thus providing access to and from the airport to the passengers of its international flights. It charges the passengers for using the bus service and earns income from sale of tickets. Would the income earned by providing bus service for the passengers of its international flights be covered under the provisions of Article 8?

Answer: The bus service provided by AIR Airline for the passengers of its international flights is a service which is so closely related to its business of operation of aircraft that it cannot be regarded as a separate business or source of income. Accordingly the income earned by AIR Airline for providing bus service for the passengers of its international flights should be covered under the provisions of Article 8.

Operation of ships – bareboat charter

JKL Shipping is a company resident in Indonesia which is engaged in the business of leasing ships on bareboat charter basis. JKL Shipping leases a ship to an Indian company UVW Shipping under a 2 year agreement. As per the terms of the agreement, the responsibility of hiring crew and bearing the operating costs during the period of lease would be of UVW. UVW would make payment to JKL only for the lease rental of the ship. Will the lease rental income earned by JKL be covered under Article 8?

Answer: The agreement entered into by JKL and UVW is on a pure bareboat charter basis. Profits arising from a bareboat charter generally do not get covered under the provisions of Article 8 as it cannot be regarded as income from 'operation of ships' in international traffic.

As per the India – Indonesia DTAA, royalties under Article 12 include payments for the use of, or the right to use, industrial, commercial or scientific equipment. Thus the lease rental received by JKL will partake the character of Royalty and be covered under Article 12 of the DTAA.

Operation of ships – Slot charter

ABC UK Ltd. is a company incorporated in United Kingdom ('UK') engaged in transporting goods in international traffic. The goods are transported by availing slot hire facility (i.e. taking certain container space onboard a ship) on ships of another company from a port in India upto a hub port abroad, from where they are transported to their final destination on a ship owned or chartered or otherwise controlled by ABC. Whether income of ABC would form a part of income from operations of ships exempt under Article 9 (dealing with Shipping, inland waterways transport and air transport) of the DTAA between India and UK?

Answer: Since, ABC is engaged in transportation of goods through ships owned or chartered or otherwise controlled by it, it shall be regarded as being in the business of operation of ships in international traffic. The transportation of goods by availing slot charter is inextricably linked to such operation of ships. Accordingly, benefit of Article 9 of the India - UK DTAA shall include the income from such slot charters / slot hire agreements.

Operation of ships – Slot charter XYZ UK Ltd. is a company incorporated in United Kingdom ('UK'), which is engaged in transporting of goods from a port in India directly to their final destination to a port abroad by availing a slot hire facility obtained by it on the ship of another company. The Company does not own, charter or control any ship. Whether income of XYZ from transport on slot hire would form a part of income from operation of ships exempt under Article 9 of the DTAA between India and UK?

Answer: Since XYZ transports goods only by availing slot charters, it cannot be regarded as being engaged in the business of operation of ships in international traffic. Accordingly, income from transport of goods through slot charters by XYZ cannot be covered under Article 9 of the India - UK DTAA.

International Traffic

Tree Shipping, a company resident in Singapore, is engaged in the business of transporting cargo by ships. Two ships Tree-I and Tree-II are operated by the company.

Tree-I only carries cargo between the ports in India from the east coast to west coast and back, let's say from Mumbai to Chennai and back.

Tree-II, while carrying cargo from Singapore to Arabian Gulf stops to load cargo at Chennai and discharges it at Mumbai before proceeding to the Arabian Gulf. What constitutes international traffic for the purpose of Article 8 of the India-Singapore DTAA?

Answer: The carriage of goods by Tree-I solely between ports in India (i.e. from Mumbai to Chennai) will not be considered as international traffic. In such a case Article 7 of the DTAA may be invoked if Tree Shipping operates in India through a permanent establishment.

Tree-II would be said to be operating in international traffic even if it has earned income from transporting cargo from Chennai to Mumbai since the said transportation is part of a voyage between two countries. In such a case, the freight income earned by Tree Shipping from Tree-II can be claimed to be exempt in India under Article 8 of the DTAA.

Residence vs. POEM

Glory Shipping is a company incorporated in Mauritius and tax resident of Mauritius. However, its POEM is situated in UAE from where key decisions with regard to its management and operations are taken. Glory Shipping carries out shipping operations in India in the course of international traffic and earns freight income from India. Under the India-Mauritius DTAA, profits derived from the operation of ships in international traffic are taxable in the country in which its POEM is situated. In which country will the profits derived from Indian operations be taxed?

Answer: As per Article 1 of the DTAA, the DTAA can be applied only to persons who are either resident of India or Mauritius or both. Therefore in a situation where the POEM of Glory Shipping is in UAE, Article 8 of India-Mauritius DTAA cannot be applied to claim taxability in UAE. The scope of the DTAA is limited to providing relief from double taxation only in India or in Mauritius. In such a situation, India could tax such profits under the Income Tax Act.

Article 8 of the India-UAE DTAA, which gives taxing rights of such profits to the country of residence, can be applied only if as per the domestic laws of UAE Glory Shipping is regarded as resident by virtue of its POEM being situated in UAE.

Participation in a pool, a joint business or an international operating agency

QPR Ltd. a company incorporated in Germany, is an international airline and also a member of the 'International Airlines Technical Pool' ('IATP'). QPR's place of effective management is situated in Germany. Members who participate in the pool share aircraft parts, aircraft tooling, ground handling equipment and manpower. In view of participation in the pool, the Company enters into separate agreements with the members of IATP for availing/giving services/facilities to the participating members. QPR has a branch office in India and has rendered services to certain participating airlines at the Delhi Airport and availed services from others at the Mumbai airport. In lieu of the services rendered, QPR has received certain sums as well as paid certain sums which are fixed and regulated by IATP. Whether QPR would be eligible to claim benefit under Article 8 of the DTAA between India and Germany with regard to the above income?

Answer: As per Article 8(1) of the DTAA, profits from the operation of ships or aircrafts in international traffic shall be taxable only in the contracting state in which the place of effective management of the enterprise is situated. Further, Article 8(4) states that provisions of Article 8(1) also apply to the profits from the participation in a pool, a joint business or an international operating agency.

QPR is a member of the IATP, the purpose of which is to provide reciprocity, technical support throughout the world, and QPR has participated in the pool of IATP under the participating agreement. Further, since there was reciprocity in rendering and availing the services, it amounts to participation in the pool as per the India – Germany DTAA. Since, place of effective management of the Company is in Germany, the profits from participation of pool would not be taxable in India as per Article 8(4) of the DTAA.

8.11 Judicial Precedents

Income arising to a UK resident from a voyage undertaken from India by availing slot hire facilities is not taxable in India by virtue of Article 9 of the India – UK DTAA – *Balaji Shipping UK Ltd (2012) 253 CTR 460 (Bom HC)*

Relying on above judgement of Balaji Shipping, in the case of Avana Global FZCO v. DCIT (International Taxation), Mumbai, [2021] 130 taxmann.com 481 (Mumbai - Trib.), it has been held that in case of assessee engaged in business of operation of ships in international traffic, benefit of article 8 of Indo-UAE Treaty must be extended to entire freight receipts, irrespective of whether earnings are relating to feeder vessels or by ships in international traffic thus including freight collections earned from cargo/containers loaded on slot of other vessels that the assessee was entitled to under the joint business/pooling arrangements.

Where activity carried out by 4 ships had nexus with operation of 141 ships operating in international traffic, which were given, benefit under Article 9 of India-Denmark DTAA, income of 4 ships alone could not be brought to tax in India under section 9 of the Income-tax Act, 1961 – *A.P. Moller Maersk A/s (2016) 76 taxmann.com 143 (Bom HC)*

Since contracting parties had defined the expression 'operation of ships' in paragraph 4 of Article 8 of the India – Brazil DTAA, meaning of such expression could not be ascertained by looking into the OECD commentaries – *Cia de Navegacao Norsul (2009) 121 ITD 113 (Mum ITAT)*

Inland Haulage Charges being part of income derived from operation of ships in international traffic are covered under Article 8 of the DTAA between India and Belgium and consequently are not taxable as and there was clearly participation in Pool, amount received from aforesaid activities was not taxable business profits in India – *Safmarine Container Lines NV (2014) 367 ITR 209 (Bom HC)*

Where assessee, foreign airlines, as member of International Airlines Technical Pool, extended line maintenance facilities to other Pool member airlines at various Indian airports, since there was reciprocity in rendering and availing of services in India, amount received from aforesaid activities was covered under Article 8(4) of DTAA between India and Germany and Article 8(1) of India-Netherlands DTAA – *KLM Royal Dutch Airlines (2017) 392 ITR 218 (Del HC)*

Where the assessee shipping company was a resident of Denmark and had been operating business wholly from Denmark, and all important decisions were taken from Denmark in form of meetings, POEM and control of the assessee was in Denmark only; and, thus, profit arising from operation of ships was not taxable in India in terms of Article 9 of the India – Denmark DTAA.- *Pearl Logistics & ExIM Corporation (2017) 80 taxmann.com 217 (Rajkot ITAT)*

In Interworld Shipping Agency LLC v. DCIT, International Taxation, Mumbai [2021] 127 taxmann.com 132 (Mumbai - Trib.), Assessee-company, a tax resident of the UAE, was engaged in business of services like ship chartering, freight forwarding, sea cargo services, shipping line agents etc. Assessee chartered ships for use in transportation of goods and containers in international waters, including to Kandla and Mundra ports as indeed other ports

in India. Assessing Officer having noted that as much as 80 per cent of profits of assessee entity were to go to one D, a Greek national, concluded that assessee was not entitled to benefits of Indo UAE tax treaty, and, accordingly, issued a draft assessment order holding that income from operation of ship was taxable in India.

It was pointed out by the assessee that the assessee is a limited liability company under the UAE laws, that it has duly obtained the requisite licence from the Department of Economic Development, that its annual accounts and audits are in accordance with the UAE laws and that its memorandum of association and articles of association were also placed on record.

It was found that assessee company had its office in UAE, it was in business there since 2000, it had expatriate employees who had been given a work permit to work in UAE for assessee company, and that main driving force of company and its director was an expatriate resident in UAE, was a Greek national, namely Dimosthenis Lalagiannis, who was in UAE for 300 days during the relevant previous year.

It was held that the requirement for presence in UAE for 183 days, for residence status under the Indo UAE tax treaty, is for the individual and not the directors of the companies which claim such a residence status.

Since assessee company was a resident of UAE, and in terms of requirements of article 4(1)(b) of Indo-UAE tax treaty, limitation of benefits provisions of article 29 of Indo-UAE tax treaty could not be pressed into service as there was nothing to even suggest that the business activities of the assessee company were not bonafide. and, thus, under provisions of article 8(1) of Indo UAE tax treaty, Assessee company was held to be protected from taxation of income in question in India.

9. Article 9 –Associated Enterprise

9.1 Introduction

Since its introduction in 2001, the subject of transfer pricing ('TP') has been gaining significant prominence. The transfer pricing law is enshrined in Chapter X of the Income-tax Act, 1961 ('the Act') and requires that the transaction between two or more associated enterprises should be conducted on an arm's length basis. While the principle of 'arm's length' requires a taxpayer to demonstrate the appropriateness or normalcy of the transaction, at the first instance the transaction is required to be between two or more 'associated enterprises'.

The term 'Associated Enterprise' has been defined in Section 92A of the Act. While Section 92A(1) of the Act is based on the Article 9(1) of the OECD Model Tax Convention ('OECD Convention'), Section 92A(2) provides certain criteria upon satisfaction of which two enterprises will be deemed to be associated enterprises.

9.2 Article 9 (1) of the OECD Convention and Section 92A(1) of the Act

Before one is to understand the import of the definition of 'associated enterprise' as defined in Section 92A of the Act, it will be important to analyze Article 9 of the OECD Model Tax

Convention. The same is reproduced below:

Associated Enterprise

“1. Where:

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Section 92A(1) provides for a similar definition of term ‘associated enterprise’. If one is to juxtapose the definition as provided in Section 92A(1) of the Act with the definition provided in Article 9(1) of the OECD Convention, following principles emerge. In terms of defining the AE relationship, it is worthwhile to understand the parameters of Article 9(1)(a) and (b) and Section 92A(1)(a) and Section 92A(1)(b).

Article 9(1)(a)& Section 92A(1)(a)	Article 9(1)(b) and Section 92A(1)(b)
<ul style="list-style-type: none"> • An enterprise of a Contracting State (X) • Participate • Directly or indirectly • In the management, control or capital • Of an enterprise of the other Contracting State (Y) 	<ul style="list-style-type: none"> • The same person • Participate • Directly or indirectly • In the management, control or capital • Of an enterprise of the Contracting State (X) and an enterprise of the other Contracting State (Y)

Thus, some of the important factors that need consideration are as under:

(a) Enterprise

Clause (iii) of section 92F of the Act defines the term “enterprise” to mean a person (including a permanent establishment of such person) who is, or is proposed to be, engaged in any of the specified activities. Clause (iiia) of the said section defines the term “permanent establishment” to include a fixed place of business through which the business of the enterprise is wholly or partly carried on. The definition of the term enterprise is exhaustive while that of the term permanent establishment is inclusive.

(b) Directly or indirectly

The direct participation within the meaning of Article 9(1)(a) and Section 92A(1)(a) means that no entity is interposed between the two enterprises in their relationship. For e.g. parent company and its subsidiary.

In the case of indirect participation, however, one or both of the enterprises make use of one or more intermediary entities in order to bring about an interconnection. For e.g. a parent company which, via its subsidiary, participates in a down-stream subsidiary.

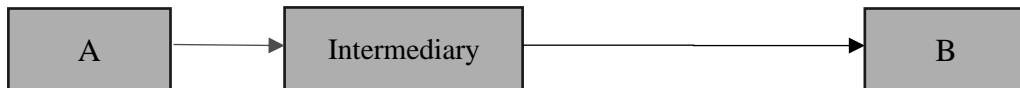
Situation 1: Direct Participation

Participation in Management, control or capital



Situation 2: Indirect Participation

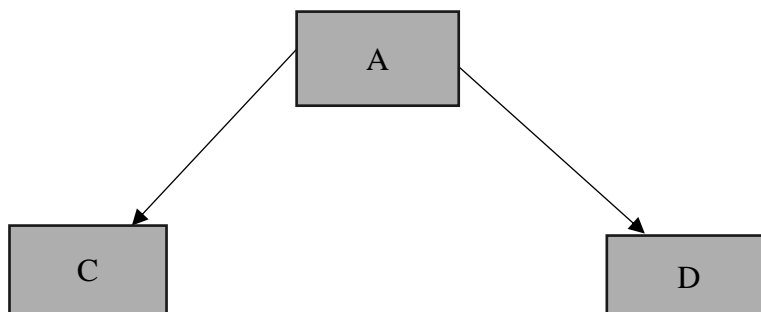
Participation in Management, control or capital



In both the situations detailed above, both A & B would be regarded as associated enterprises.

Alternatively, participation in management, control or capital by one or more persons in two enterprises may be either direct or indirect as described below:

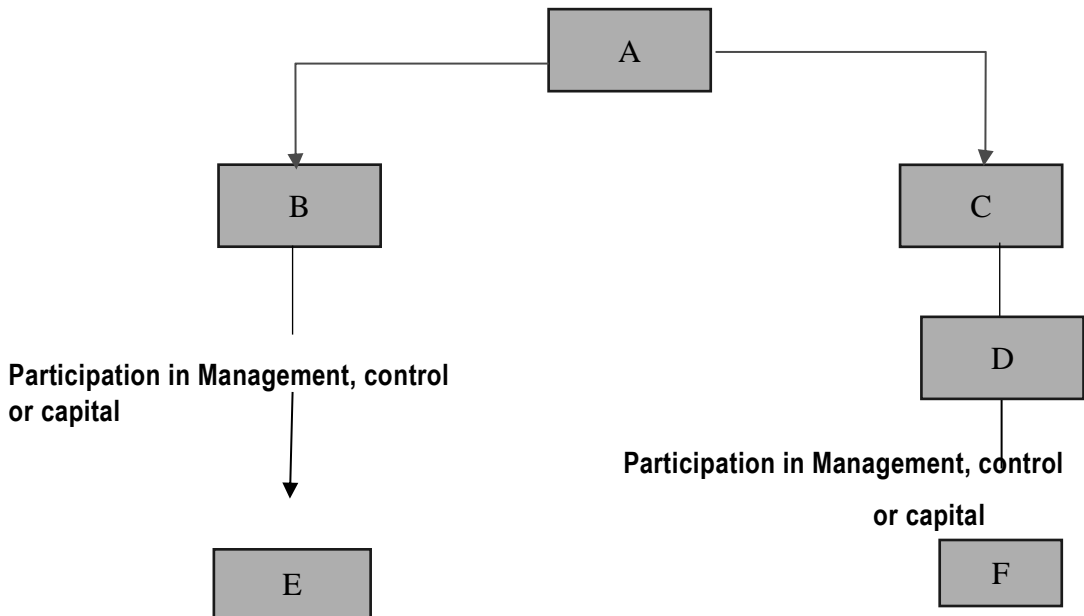
Situation 3: Direct Participation



Participation in Management, control or capital

In the above situation, C & D are associated enterprises by virtue of A participating in the management, control or capital of both C & D.

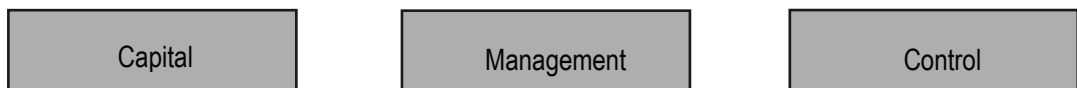
Situation 4: Indirect Participation



In the above example, A participates in the management, control or capital of E through B and of F through C and D. Consequently, E & F would be considered as associated enterprises owing to indirect participation by A in both E and F.

9.3 Section 92A(2) of the Act

While the OECD convention stops at Article 9(1) vis-à-vis the definition of ‘associated enterprise’, the Indian TP regulations provide for specific and exhaustive definition of the term ‘associated enterprise’. The specifics with respect to the various modes by which capital, management or control may be exerted by one enterprise on the other is provided in sub-section (2) of Section 92A. The clauses (a) to (m) of sub-section (2) of Section 92A could be classified as under:



As one could observe, there exists a possibility that certain genuine third party transactions could also get covered under the definition of the term ‘associated enterprise’. Some examples of the same could be as under:

- Clause (c) of Section 92A(2) - Bank giving a loan to third parties, if loan constitutes > 51% of total assets of the customer
- Clause (d) of Section 92A(2) - Bank providing a guarantee for its customer if guarantee constitutes > 10 % of total borrowings of the customer
- Clause (i) of Section 92A(2) Global arrangements

9.4 Peculiar situations

- *Interplay between Section 92A(1) and Section 92A(2).*

An issue that arises is whether the 13 instances mentioned therein are exhaustive of the situations where there can be associated enterprises or they are merely illustrative of the forms of participation in management or control or capital contemplated in sub-section (1). To put it differently, is it required for the taxpayer to satisfy one of the clauses mentioned in Section 92A(2) for the entities to a transaction to qualify as associated enterprise. Could one enterprise participate in 'capital, management or control' of other enterprise without satisfying or falling within any of the clauses to Section 92A(2) of the Act.

Section 92A(2) begins with a phrase '*For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if*'. Consequently, one could read that for two enterprises to be termed as associated enterprises under Section 92A(1) of the Act, one of the conditions mentioned in Section 92A(2) needs to be satisfied. Further, if one goes by the memorandum explaining the Finance Act, 2002, wherein sub-section (2) was amended, then it would appear that unless any of the criteria mentioned in subsection (2) are satisfied, two enterprises would not be regarded as associated enterprises even though they fulfill the general criteria of participation in management or control or capital. However, this proposition cannot be said to be free from doubt and another view is also possible.

The Chennai Tribunal pronounced an important ruling in the case of Orchid Pharma Limited¹⁵⁰ on the basic definition of associated enterprises under the Indian transfer pricing regulations. It held that even if two enterprises satisfy any of the relationship criteria as defined under section 92A(2) of the Act, they cannot be regarded as associated enterprises unless they satisfy the basic condition of "participation in the capital, management or control" as specified under section 92A(1) of the Act.

- *Transaction between a head office and a branch*

Company A, a company resident in India has a Branch in Singapore. Company A has undertaken a transaction with its branch in Singapore for which Company A has made payment to the Branch. Will such a transaction be considered as a transaction between two 'associated enterprises'?

With regard to above situation, one will have to understand that the Branch will not be considered as a taxable entity separate from Company A. Consequently, the transaction will not be between two 'enterprises' but will be with itself. Consequently, Company A and its Branch in Singapore would not be considered as 'associated enterprises'.

Let's presume that Company A instead of being a tax resident of India is a tax resident of

¹⁵⁰(2017) 182 TTJ 809 (Chenn ITAT)

Singapore and has a Branch in India. Now if Company A has undertaken a transaction with its Indian Branch, will Company A and its Indian Branch be considered as 'associated enterprises'.

With regard to the above situation, one will have to refer to the definition of the term 'enterprise' as provided in Section 92F(iii) of the Act. The term 'enterprise' has been defined to mean a person (including a permanent establishment of such person). The term 'permanent establishment' has been defined in Section 92F(iia) of the Act. If one is to analyze the definition of the term 'permanent establishment' one could observe that it is an inclusive definition. The Indian Branch would therefore be considered as the 'permanent establishment' of Company A. Consequently, Company A and its Indian Branch would be considered as 'associated enterprises'.

Article 9(1) of the OECD Convention further provides that if as a result of special relations between the two associated enterprises, the taxable profits of either of the entity do not reflect the true picture, then the profits to either of the entity could be accrued and tax accordingly.

Section 92 of the Income-tax Act, 1961 also provides for computation of income having regard to the arm's length price of the transactions between associated enterprises.

9.5 Article 9(2) of the OECD Convention

Paragraph 2 of Article 9 of the OECD Convention reads as under:

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 of Article 9 may give rise to economic double taxation (i.e. taxation of the same income in the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B. Paragraph 2 of Article 9 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve such double taxation.

It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B

considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length.

Article 9(2) does not specify the method by which an adjustment is to be made. It is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article.

It is not the purpose of the paragraph to deal with what might be called "secondary adjustments" which would be required to establish the situation exactly as it would have been if transactions had been at arm's length. Nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

The provisions of secondary adjustment are internationally recognized and are already part of the transfer pricing rules of many leading economies in the world. In order to align the Indian transfer pricing provisions in line with the OECD transfer pricing guidelines and international best practices, the Finance Act, 2017 inserted a new section 92CE to provide that with effect from assessment year 2018-19, an assessee shall be required to carry out secondary adjustment in specified situations where a primary adjustment exceeding one crore rupees has been made to the transfer price.

9.6 CBDT Press Release on acceptance of MAP/ APA applications

The CBDT had earlier taken a position that for the purpose of Mutual Agreement Procedure (MAP) in transfer pricing matters and also for the purpose of bilateral Advance Pricing Agreements (APA), it would not accept cases where the Associated Enterprises are resident of countries whose DTAA with India do not contain Article 9(2) or similar provisions for corresponding adjustment. This led to refusal of Transfer Pricing MAP/ Bilateral APA applications sought to be filed in cases concerning residents of France, Germany, Singapore, Italy, etc.

The OECD Transfer Pricing guidelines have always maintained that Article 9(2) or its equivalent may not be needed to undertake bilateral APA and MAP resolution for transfer pricing cases. In keeping therewith, the CBDT has relaxed its stand and announced vide a Press Release dated 27 November 2017 that it will accept Transfer Pricing MAP and bilateral APA applications regardless of the presence of Article 9(2) or equivalent article in the DTAA.

10. Article 10 – Dividend

10.1. Introduction

Generally, there are 2 types of capital normally employed by the shareholders - Equity capital and the Debt Capital and they may therefore be represented by varying investment instruments. Payments made under equity instruments are usually classified as dividends whereas payments made under debt instruments are usually classified as interests.

It has been always the endeavour of the Shareholders to consider the cost of the capital for computing effective shareholder's return. For an effective post tax return debt capital is always

preferred by the shareholders as debt enhances the post-tax return as cost of the debt reduces the corporate taxes giving rise to larger distributable profits for the shareholders.

Moreover, withholding taxes on Interest on debt capital is lower as compared to the dividend on Equity capital and hence thinly capitalised structure under normal circumstances will reduce the cost of capital substantially thereby enhancing the return on capital significantly unless there are regulations on the debt capital ratio.

Article 10 of the UN and OECD Model Convention deal with the taxation of dividend whereas Article 11 of the UN and OECD Model Convention deal with taxation of interest.

The clauses of Article 10 as per the UN Model Convention are as under;

Article 10(1): Taxability of dividend in Resident Country

Article 10(2): Taxability of dividend in Source Country

Article 10(3): Meaning of the term dividend

Article 10(4): Permanent Establishment Situation

Article 10(5): Extraterritorial taxation of dividend

The clauses of Article 11 as per the UN Model Convention are as under;

Article 11 (1): Taxability of interest in Resident Country

Article 11(2): Taxability of interest in Source Country

Article 11(3): Meaning of the term interest

Article 11(4): Permanent Establishment Situation

Article 11(5): Extraterritorial taxation of interest

Article 11(6): Arm's Length Condition

From the Company view point, debt is always preferred over equity as a high debt: equity ratio can reduce the tax on business profits, as explained here under;

Particulars	Cost of Debt	Cost of Equity
Nature of Return	Interest Paid on Debt Instruments	Dividend paid on Equity Instruments
Tax Rate as per DTAA (OECD)	10%	15%
Deductible as expense to Company	Yes	No
Any Tax Benefit to Company	Yes. Tax @ 30% less to the extent of interest paid	No

10.2. Article 10-Dividend

We shall first deal with the provisions of the Taxation of Dividend as per Article 10 of UN Model Convention.

10.2.1 Article 10(1): Taxability of dividend in Resident Country

"Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State."

Therefore, it may be noted that the first right to tax is with the Resident Country. But the words "may be taxed" means that there is a possibility of tax in the Source Country as well.

This Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State. It does not, therefore, apply to dividends paid by a company which is a resident of a third State or to dividends paid by a company which is a resident of a Contracting State but dividend paid are attributable to a permanent establishment which an enterprise has in the other Contracting State.

The important phrases used in this article are "Dividend paid" and "Company".

As per Para 1 of the OECD Commentary, *"the term 'paid' has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or custom."*

Under the ITA, in the Chapter dealing with Profits and Gains of Business or Profession the term 'paid' means *"actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under the head "Profits and gains of business or profession"*.

Therefore, it is clear that the term paid has a larger connotation and would include the dividend declared by a company and incurred as liability by appropriate shareholders' consent in case of final dividend and appropriate board formalities in case of interim dividend.

As per Section 8 of ITA, while computing total income of an assessee, dividend shall be taxed when the same is *declared, distributed or paid* by the Company.

As per Section 9(1)(iv) of ITA, "dividend *paid* by an Indian Company outside India" will constitute income deemed to accrue or arise in India. .

Section 8 of ITA states that dividend income is to be included in the total income in the year in which it is declared, distributed or paid. Accordingly, it can be said that dividend is to be taxed at the time of declaration, distribution, or payment, whichever is earlier. Generally, taxability arises at the time of declaration as the same is earlier in time sequence. Thus, in cases where any regulatory approval is needed to declare dividend then in such a case dividend would be taxable in the hands of recipients only upon approval being granted as income does not accrue prior to such approval. This view finds support from the case of *Nonsuch Tea Estate Ltd [1975] 98 ITR 189 (SC)*. On the other hand, if RBI approval is required only for remittance of dividend abroad then the income in form of dividend will accrue on declaration of dividend irrespective of

time of obtaining RBI approval. Reliance can be placed on *Bhai Sunder Das & Sons Co. (P) Ltd [2003] 259 ITR 33* and *Super Scientific Clock & Co. [1999] 238 ITR 731*.

In this regard, it is pertinent to note the decision of Bombay High Court in the case of Pfizer Corpn. [2003] 129 Taxmann 459. In this case the Hon. Bombay High Court while dealing with section 9 of the Act held that "but for section 9(1)(iv) payment of dividend to non-resident outside India would not have come within section 5(2)(b). Therefore, section 9(1)(iv) is an extension to section 5(2)(b). In case where the question arises of taxing income one has to consider place of accrual of the dividend income. To cover a situation where dividend is declared in India and paid to non-resident out of India, section 5(2)(b) has to be read with section 9(1)(iv). Under section 9(1)(iv), it is clearly stipulated that a dividend paid by an Indian company outside India will constitute income deemed to accrue in India on effecting such payment. In section 9(1)(iv), the words used are 'dividend paid by an Indian company outside India'. This is in contradiction to section 8 which refers to a dividend declared, distributed or paid by a company. The word 'declared or distributed' occurring in section 8 do not find place in section 9(1)(iv). Therefore, it is clear that dividend paid to non-resident outside India is deemed to accrue in India only on payment."

Further, only distributions from Company is covered i.e. a body corporate under the local laws of the country. Indian LLP, US LLC, U.A.E FZC would also qualify as a Company. However, profits distributed by other entities like partnership firms would not be covered.

10.2.2 Article 10(2): Taxability of dividend in Source Country

"However, dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

- (a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;
- (b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid."

Article 10(2) of OECD Model is similar to Article 10(2) of UN Model. However, OECD Model specifies the percentage for clause (a) & (b) at 5 % & 15 % respectively.

This Article enables the Source Country a limited right to tax dividend at concessional rate. The benefit of concessional tax rate is given subject to fulfilment of certain conditions. Accordingly, the recipient of dividend should be:

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- (a) a resident of other Country;
- (b) a Company;
- (c) a beneficial owner of Dividend; and
- (d) holds at least prescribed percent of the capital of the Company paying dividend.

The reasons for lower tax rate are for the prevention of double economic taxation and encouragement of investment. A lower tax rate generally has been subjected to the condition of holding a prescribed percentage of capital because it is reasonable that payments of profits by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation.

The term "*may also be taxed*"

Article 10(1) uses the term '*may be taxed*' while conferring right on Country of residence of recipient. Article 10(2) at the same time uses the term '*may also be taxed*' while conferring right of taxation on Source Country. However, Source Country may or may not tax the dividend depending upon the domestic tax law of Source Country.

Prior to 1 April 2020, Dividend Distribution Tax (DDT) @15% (plus applicable surcharge and cess) is payable under section 115-O of the ITA by the distributing domestic company on distribution of dividend. Further, the Finance Act, 2018 has amended section 115-O to provide that DDT @ 30% (plus applicable surcharge and cess) shall be payable on deemed dividend referred to in section 2(22)(e) of the ITA. Such dividend on which DDT has been paid in terms of section 115-O, is exempt in the hands of the recipient shareholder under section 10(34) of the ITA. Treatment of Deemed Dividend and treaty provisions is covered later in Para 10.2.6 of this module.¹⁵¹

Similarly, as per the tax laws of Malaysia, where a company incorporated in Malaysia makes dividend payment to a non-resident, there is no withholding tax requirement. Therefore, in a situation where a Malaysian Subsidiary Company distributes dividend to Indian Holding Company, the Indian Holding Company will not be liable to tax in Malaysia. However, in India, dividend received from foreign company will be liable to tax at 30% or 15% under the provisions of section 115BBD. Provisions of Section 115BBD and Section 115-O have been dealt with later in Para 10.2.7 of this module.

Therefore, a combined reading of Article 10(1) and 10(2) suggests that Model Conventions provide for the taxability of the dividend as follows:

- At first instance, dividend is taxed in the Country of Residence of the recipient;
- Besides, dividend is also taxed in the Country of Source according to local tax laws. However, if certain given conditions are fulfilled, then the taxability in the Country of Source is at a concessional rate. Of course, DTAA would separately provide mechanism

¹⁵¹ Finance Act, 2020, has amended section 115-O. With effect from 1 April 2020, the DDT regime has been abolished and the dividend income is taxable in the hands of recipients i.e. shareholders.

of relief such as credit for taxes etc.

At this stage, it is pertinent to draw attention to the case of *Turquoise Investment and Finance Ltd* [2008] 300 ITR 1, wherein the Hon'ble Supreme Court held that dividend income earned in Malaysia by an Indian Resident was not taxable in India though Indo-Malaysia treaty has similar wordings in article 10(1) and 10(2) as the UN model viz article 10(1) uses phrase 'may be taxed in' and article 10(2) uses phrase 'may also be taxed in'. The Court endorsed the view that on a plain reading of relevant article the source country i.e. Malaysia alone was entitled to tax the dividend. In concluding this the Hon. Court relied upon the decision in *CIT v SRM firm* [1994] 208 ITR 400 (Mad) which was approved by the Hon. Supreme Court in *CIT v PVAL Kulandagan Chettiar* [2004] 267 ITR 654 (SC).

A contrary view was taken in the case of *Roop Rasyan Industries Pvt Ltd vs ACIT* [2013] 36 *taxmann.com* 287 (Mumbai Tri) wherein the facts were that the assessee, a Company being a Resident of India received dividend from a Singapore company, offered it to tax @ 30%. However, later, they revised their return of income relying upon Article 10 of the DTAA between India and Singapore, and taxed the dividend income @ 10% (since it was holding more than 25% stake). However, the Assessing Officer did not accept the contention of the assessee as Article 10(2) of the DTAA deals with taxability of the dividend in the state in which the dividend was declared and not the resident state where the dividend was received. Accordingly, the Assessing Officer taxed the dividend income in question at normal rate of 30 per cent. The Hon'ble Tribunal upholding the view of the Assessing Officer held that Article 10(2) of DTAA deals with the percentage of taxability of the dividend in the contracting state of which the company paying dividend is a resident, if the dividend is also taxed in the said contracting state. Since, in the case in hand, the dividend was not taxable in Singapore of which the company paying the dividend was resident, Article 10(2) of DTAA was not at all relevant. Even otherwise, for the purpose of taxability of dividend in India and particularly the rate of tax, only Article 10(1) of DTAA is relevant.

It may be noted that the decisions in the context of India Malaysia treaty as referred above are not in line with the international jurisprudence on the subject.

The term "*beneficial owner*" & "*capital*"

There are 2 conditions specified for concessional tax treatment (a) beneficial owner and (b) holding of specified percentage of capital.

Both OECD and UN Models have used the term "Beneficial Owner" and "Capital" but not defined the term.

As per Article 3 (2) of the OECD Model Convention "*As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of the State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.*"

"Beneficial Owner"

Since the term beneficial owner is not defined under the treaty it is open for the contracting state to seek support from the domestic tax law if the term is defined therein. It complicates the matter further when the term is not defined even under the domestic law of the contracting states.

Commentary on OECD Model Convention states that *"the term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance"*. In other words, it should be interpreted with reference to the context of the treaty and intentions with which it is used.

Since the UN & OECD Model Convention use the term "beneficial owner" rather than the general term "owner", it intends to give the benefit of withholding taxes at a reduced rate only to the person who can be loosely described as the "final owner of income". The concept of "final owner of income" can be elaborated with the help of attributes of ownership of income such as the right to possess, use or manage income, the power to alienate and ability to consume waste or destroy, the risk of depreciation and hope of appreciation.

The condition of beneficial ownership is an anti-tax avoidance provision, which is incorporated with the objective of avoiding treaty shopping by interposing an intermediary company to access a particular DTAA. The rationale behind finding this condition in this Article seems to suggest that it is possible to introduce a conduit to earn dividend income more easily on back to back basis with a purpose to abuse treaty by incorporating a conduit company in the State which has favourable tax treaty with the State where company paying the dividend is a resident. Generally, it can be understood that recipient acting purely as nominee or agent is not a beneficial owner. Beneficial owner is the principal for whose account the agent or nominee is acting. The purpose of Article 10(2) is not to grant benefit of treaty to the agent or nominee or conduit entity.

While one person may be beneficial owner of assets, another could be beneficial owner of income e.g. a corpus beneficiary vs. income beneficiary. The trustee is legal owner but does not personally enjoy the attributes of ownership, use and risk. The trustee is holding the property for someone else and ultimately it is that someone else who has the use, risk and ownership control of the property. The word "beneficial" distinguishes the real or economic owner of the property from the owner who is merely legal owner, owning the property for someone else's benefit i.e. beneficial owner. The commentary for article 10 of the Model Convention explains that one should look behind "agents and nominees" to determine who is the beneficial owner. Also, a "conduit" company is not a beneficial owner. In these three examples, the person – the agent, nominee and conduit company – never has any attribute of ownership of the dividend. The beneficial owner is another person.

Further, as per the amendment brought by the Finance Act, 2015 w.e.f. 1 April 2016 to section 139, beneficial owner has been defined to mean as under;

"Explanation 4. - For the purposes of this section "beneficial owner" in respect of an asset means an individual who has provided, directly or indirectly, consideration for the asset for the immediate or future benefit, direct or indirect, of himself or any other person.

Explanation 5.—For the purposes of this section "beneficiary" in respect of an asset means an individual who derives benefit from the asset during the previous year and the consideration for such asset has been provided by any person other than such beneficiary.

It may be tested in future whether the definition as provided above now has the appropriate context to Article 10 and 11.

Important Judicial Pronouncements on the term "beneficial owner"

In case of *NatWest – Advance ruling No. P 9 of 1995 (220 ITR 377)* a single UK based entity owning 100% subsidiaries applied for an Advance ruling. In the question before AAR beneficial treatment of Indo – Mauritius treaty was sought to be applied for, inter alia, dividend income. AAR found that Mauritian companies were not beneficial owner of shares. It rejected the application on the ground that transaction was 'designed prima-facie for the avoidance of tax' as Mauritius subsidiaries were incorporated only as a conduit for routing the investment from UK to India. Mauritius route was considered as intermediate step devoid of commercial sense. As against this, in the case of *AIG (224 ITR 473)* it was observed that investment company in Mauritius was not mere insertion of intermediate step devoid of commercial purpose. Shareholders were located in different part of the world (though belonging to same group) and Mauritius was suitable central location for all of them. It was also demonstrated that cost for legal accounting and professional services in Mauritius were comparatively economical compared to other jurisdiction. Based on this AAR allowed concessional treatment of tax under India – Mauritius DTAA.

In the case of *Prevost Car Inc (2008 TCC 231)*, in the context of payment of dividends to Netherlands holding company, the Canadian Tax Court observed that *"the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short, the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income"*.

In case of *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA London Branch [2006] EWCA Civ 158*, a subsidiary company, which issued loan notes to various bond holders, had a back-to-back loan agreement with its parent company. As part of the loan agreement, the subsidiary was bound to pay the bond holders whatever interest amounts were received from its parent company. The subsidiary therefore had no power of disposition over the funds received from the parent company and thus was held not to be the beneficial owner thereof.

In the case of *National Travel Services (2018) 401 ITR 154 (SC)*, a Supreme Court division bench referred the matter to a larger bench on the issue of whether a shareholder must be a 'registered shareholder' and also a 'beneficial shareholder' to trigger deemed dividend taxability under section 2(22)(e). It prima facie opined that after amendment of year 1988 carried out in section 2(22)(e), in order to invoke provisions of said section, 'shareholder' has only to be a person who is beneficial owner of shares. One cannot be a registered owner and beneficial owner in sense of a beneficiary of a trust or otherwise at the same time. It is clear therefore that

the moment there is a shareholder who need not necessarily be a member of company on its register, who is a beneficial owner of the shares, the section gets attracted without anything more. To state, therefore, that two conditions have to be satisfied, namely, that shareholder must first be a registered shareholder and thereafter, also be a beneficial owner is not only mutually contradictory but is plainly incorrect. .

It is also worthwhile to note that CBDT vide Circular No 789 dated April 13, 2000 has clarified that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the Indo - Mauritius DTAA.

However, the Apex Court in the case of *Vodafone International Holding B.V. v. Union of India [2012] 204 Taxman 408 (SC)* held that the beneficial circular would not preclude the tax authorities from denying treaty benefits if a Mauritius entity, without substance is used as device to avoid tax. Again, in *AB Mauritius (2018) 90 taxmann.com 182 (AAR)*, the AAR observed that TRC gives a presumptive evidence of beneficial ownership and not conclusive presumption. Thus, it is open for the tax department to ignore the device, take into consideration the real transaction between the parties and subject it to tax dehors the TRC. In terms of section 90(4) of the Act, the TRC is the fundamental document for availing of any DTAA benefit. Further, some Treaties, such as the Singapore Treaty, contain Limitation of Benefits (LOB) clause, in such cases even with a valid TRC, the claim needs to be tested in the context of LOB parameters.

"Capital"

Further, as regards the term capital being used in clause 2(a), since the same is not defined in the Model Conventions, a reference can be drawn from domestic laws. As per the UN Model, the term capital should be used in the sense in which it is used for the purposes of distribution to the shareholder (in particular, the parent company).

In the Indian scenario, as per the Companies Act, 2013, the term 'Capital' is to be understood as share capital of the company which includes equity shares and preference shares. For the purpose of DTAA also the term 'Capital' can be understood as shares or stock which gives ownership rights in the company and which are entitled to dividend that is subject matter of this Article. When particular contribution or loan from shareholder or concerns in which shareholder is interested does not form part of capital in the balance sheet but due to 'thin capitalisation rules', the income derived in respect of such loan is treated as dividend under Article 10, the value of such contribution or loan should also be taken as 'Capital'.

As per the UN Commentary, "capital" has not been defined. However, reference has been drawn to include the following;

- Capital means paid up capital shown at face value in the Company's Balance Sheet
- Reserves such as Share Premium not be taken into account
- Differences in voting rights, types of shares etc. not to be considered
- Amounts treated as capital under 'thin capitalization' to be considered

- In case of bodies having no share capital, like Company limited by guarantee, capital means total of all the contributions to the body which are taken into account for the purpose of distributing profits
- Some DTAA's use the term voting power instead of capital. This means equity shares only

Substantial Shareholder and Period of Shareholding

It may be noted that OECD Model Convention restricts the tax in the source country to 5% for direct investment and 15% for portfolio investment. A lower rate of 5% is provided for when dividend is paid by Subsidiary Company to Holding Company to prevent double economic taxation and facilitate international investment. The UN Model Convention has not provided any tax rates but has left it to be established by way of bilateral negotiations.

As per the OECD Model Convention, shareholding should be greater than or equal to 25% of the investee company's capital (only direct shareholding). However, as per UN Model Convention, shareholding should be greater than or equal to 10% of the investee company's capital (only direct shareholding).

While providing for beneficial ownership no minimum period of holding is prescribed. This means that if the investing company beneficially holds the required percentage of shares at the time when dividend is paid, the lower rate of tax would apply. In this context, the Commentary on UN Model Convention states that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which the Article applies, i.e. in most cases the situation existing at the time when the dividends become legally available to the shareholders. Internal laws of certain OECD member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received.

However, this lower tax rate is not applicable in case of abuse of provisions. (eg. shareholding increased to 25% or 10% just before making payment of dividend primarily for the purpose of securing benefit or where the qualifying holding was necessary, primarily for obtaining such reduction). This is a treaty abuse and not the intent of the legislature. Therefore, if found appropriate, the Contracting State at the time of entering into tax treaty can add the following lines;

"Provided that this holding was not acquired primarily for the purpose of taking advantage of this provision"

Withholding tax rate under Treaty vs DDT rate as prescribed under the Act¹⁵²

There was an on-going litigation on the issue as to whether the beneficial rate prescribed under the tax treaty would override the rate prescribed under Section 115-O of the IT Act.

Further, whether withholding tax rate should be lower of as provided TDS rate in treaty

¹⁵² It may be noted that Dividend Distribution Tax has since been removed and classical method of taxing distribution, where the dividend is taxed in the hands of recipient has been restored. However, for the sake of completion of discussion the case laws are being discussed here.

for dividend or as prescribed under domestic law; this issue is settled by the *Special Bench of ITAT, Mumbai*¹⁵³ held that:

“where dividend is declared, distributed or paid by a domestic company to a non-resident shareholder(s), which attracts Additional Income Tax (Tax on Distributed Profits) referred to in Sec.115-O of the Act, such additional income tax payable by the domestic company shall be at the rate mentioned in Section 115 O of the Act and not at the rate of tax applicable to the non-resident shareholder(s) as specified in the relevant DTAA with reference to such dividend income.

Nevertheless, we are conscious of the sovereign’s prerogative to extend the treaty protection to domestic companies paying dividend distribution tax through the mechanism of DTAA’s. Thus, wherever the Contracting States to a tax treaty intend to extend the treaty protection to the domestic company paying dividend distribution tax, only then, the domestic company can claim benefit of the DTAA, if any.”

Thus, the question before the Special Bench is answered, accordingly.

Taxation is a sovereign power of the State- collection and imposition of taxes are sovereign functions. Double Taxation Avoidance Agreement is in the nature of self-imposed limitations of a State’s inherent right to tax, and these DTAA’s divide tax sources, taxable objects amongst themselves. Inherent in the self-imposed restrictions imposed by the DTAA is the fact that outside of the limitations imposed by the DTAA, the State is free to levy taxes as per its own policy choices. The dividend distribution tax, not being a tax paid by or on behalf of a resident of treaty partner jurisdiction, cannot thus be curtailed by a tax treaty provision.

Recently, the Special Bench (‘SB’) of the Tribunal in *DCIT v. Total Oil India Pvt. Ltd.*, [2023] 149 taxmann.com 332 (Mumbai – Trib.) (SB) has held that the provisions and tax rates as provided for under Section 115-O of the Act would prevail over the rates prescribed under the DTAA. The Hon’ble SB whilst relying on the decision of the Hon’ble High Court of Bombay in the case of *Godrej & Boyce Mfg. Co. Limited v. DCIT*, [Godrej & Boyce Mfg. Co. Limited v. DCIT, [2010] 328 ITR 81 (Bom. HC) subsequently confirmed in *Godrej & Boyce Mfg. Co. Limited v. DCIT*, [2017] 394 ITR 449 (SC)] categorically held that in terms of Section 115-O of the IT Act, Dividend Distribution Tax (‘DDT’) is a levy on the “distributed profits of the company” and not on the “dividend income” of the non-resident shareholder.

Further, it was observed that Section 115-O is a complete code in itself and it is a separate charge on the distributed profit of the company which is completely independent and divorced from the concept of “total income” under the IT Act. Whilst holding so, the Hon’ble SB referred to the India-Hungary DTAA, wherein the beneficial rate for DDT is specifically provided for. In

¹⁵³*Deputy Commissioner of Income Tax Circle 11(3)(1), Mumbai vs Total Oil India Pvt. Ltd.*, (Mumbai SB ITAT) ITA NO.6997/MUM/2019 (A.Y.2016-17)

view thereof, the SB observed that wherever the benefit was intended to be granted, the countries have specifically agreed in the DTAA to that effect. Therefore, it was held that domestic companies are not entitled to take/claim benefits on the DDT paid under Section 115-O of the Act unless the DTAA specifically provides such benefit.

10.2.3. Article 10(3): Meaning of the term dividend

"The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."

Dividend in common parlance means a sum paid to or received by a shareholder proportionate to his shareholding in a Company out of the total sum distributed or distribution of profits to the shareholders by Companies limited by shares.

Thus this definition incorporates the meaning in three parts, one as income from shares or other rights not being debt claims, two as participation in profits and the third part being other corporate rights as per the domestic laws of the state where company paying the dividend is resident.

As per the provisions of section 2(22) of the ITA, "dividend" includes-

- (a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;
- (b) any distribution to its shareholders by a company of debentures, debenture- stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalised or not;
- (c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;
- (d) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933 , whether such accumulated profits have been capitalised or not;
- (e) any payment by a company, not being a company in which the public are substantially interested, of any sum, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power, or to any concern, in which such shareholder is a member or a partner and in which he has a substantial interest or any payment by any such company on behalf,

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or for- the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits;

While dividend does not include the following:

- (i) a distribution made in accordance with (c) or (d) (as mentioned above) in respect of any share issued for full cash consideration, where the holder of the share is not entitled to participate in the surplus assets in the event of liquidation;
- (ia) a distribution made in accordance with (c) or (d) (mentioned above) in so far as such distribution is attributable to the capitalised profits of the company representing bonus shares allotted to its equity shareholders after the 31st day of March, 1964, and before the 1st day of April, 1965;
- (ii) any advance or loan made to a shareholder or the said concern by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company ;
- (iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off;
- (iv) any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 68 of the Companies Act,2013;
- (v) any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company (whether or not there is a reduction of capital in the demerged company).

The term “*Jouissance Shares*” as used in Article 10(3) means written documents that carry right to participate in company profits and proceeds of liquidation. For easy understanding “*Jouissance Shares*” are corporate forms of sleeping partners. “*Jouissance Rights*” are the rights in the property of the company which shareholders would be entitled to but do not carry voting power or other controls.

Further, it may be noted that the article draws reference to the domestic tax laws to know the characteristics of dividend being a source state meaning of the dividend

The UN Model Convention has specified certain situations wherein the distributions to shareholders may be treated as dividend and may not be treated as dividend.

Situations where distribution is treated as dividend;

- Distributions of profits by Limited Liability Companies, Co-operative Societies are generally regarded as dividends
- Distribution on capital reduction and profits on liquidation is regarded as dividend
- Issue of Bonus Shares is treated as dividend as it is "other corporate rights"
- Purely contractual rights (not being debt claims) not involving any membership in company (e.g. *jouissance shares* etc.) will be such corporate rights. However, to be

classified as dividend such corporate rights should be subjected to the same taxation treatment as income from shares.

Situations where distribution is not treated as dividend;

- Distributions of profits by partnership are not dividends, unless partnerships are subject to substantially similar fiscal treatment that is applied to companies
- Interest on convertible debentures (before conversion) is not dividend as it is debt claims
- Debt-claims participating in profits do come in this category.
- Distributions by a Company which has the effect of reducing the membership rights, for instance, payments constituting reimbursement of capital in any form, is not regarded as dividend eg buy back of shares

As stated above, reimbursement of capital in any form does not normally constitute dividends. However, if such benefit / payment, by fiction of law is treated as dividend then for the purpose of DTAA also same would be treated as dividends. For example, distribution to shareholders on liquidation or reduction of capital to the extent to which company possesses accumulated profits is regarded as "dividend" under 2(22) of the ITA; such distribution is also to be regarded as dividend for the purposes of DTAA.

Many Countries have extended the meaning of dividend beyond the scope of normal distribution of profits to include benefits/ advantages derived by shareholders in various form. Such benefits / advantages enjoyed by a concern in which shareholders are interested or by relative of shareholders may well be treated as dividend.

The UN Model Convention has stated that "*The benefits to which a holding in a company confers entitlement are, as a general rule, available solely to the shareholders themselves. Should, however, certain of such benefits be made available to persons who are not shareholders within the meaning of company law, they may constitute dividends if:*

- *the legal relations between such persons and the company are assimilated to a holding in a company ("concealed holdings") and*
- *the persons receiving such benefits are closely connected with a shareholder; this is the case, for example, where the recipient is a relative of the shareholder or is a company belonging to the same group as the company owning the shares."*

Therefore, as stated above, the provisions of section 2(22)(e) of the ITA treating loan to shareholders or concern in which he is interested etc. as dividend, is one such example.

As stated above, buy back of shares does not amount to dividend as per Article 10 as well as section 2(22) of the ITA read with CBDT Circular No.3/2016 dated 26 February 2016.

However, in an earlier ruling pronounced by the Authority for Advance Rulings ('AAR'), in the case of *Otis Ltd (AAR No. P of 2010 dated 22.03.2012)*, based on peculiar facts of the case, buy-back of shares by Mauritian company was re-characterized as distribution of dividend and it was held that, the distribution would fall under "Dividend" within the provisions of the Act and

Article 10 of India-Mauritius DTAA. While coming to this conclusion, the AAR observed the following:

- The Indian company did not declare dividends since the year of introduction of Dividend Distribution Tax even though it had significant reserves
- There was selective buy-back of shares only by the Mauritius entity
- Profits were proposed to be repatriated through buy-back of shares to mitigate tax incidence in India
- The proposed transaction was a colourable device

Similar view was taken by AAR in the case of XYZ India [2012] 206 Taxmann 631.

The commentary on UN & OECD Model Convention states that the definition of “Dividend” provided in the model convention merely mentions examples which are found in majority of member countries’ laws and that it is open to the Contracting States through bilateral negotiations, to make allowance for peculiarities of their laws and to agree to bring under the definition of “dividends” other payments by companies falling under the Article.

10.2.4. Article 10(4): Permanent Establishment Situation

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply”.

Article 10(4) of the OECD Model is similar to provisions of the UN Model. However, OECD Model does not specifically refer to performing “Independent Personal Services” and consequently “Fixed base”. OECD draft as revised in 2001 does not deal with Independent Personal Services separately but considers it as part of Business income and therefore this distinction in clause. However, broadly speaking there would not be any material difference in treatment of this Article under both the models.

This Article deals with shares/rights etc. which generate dividend and are effectively connected to the PE. In such a case, the normal taxing provision of article 10(1) and 10(2) would not be applicable but provisions of article 10(4) come into play. Accordingly, the Country where PE is situated would be entitled to tax such income as business income. This will give a Country where PE exists a right to tax entire income attributable to PE so that the question of treating dividend as distinct item does not arise.

Where share/securities are held as stock in trade, the dividend income may well form part of the business profits. Similar should be the situation for holding which is effectively connected with PE. This article, which enables treatment of dividend as part of business, ensures that non-resident shareholder does not get greater advantage than resident. It is recognized in both the

Commentaries (i.e. UN and OECD) that application of this provision may present difficulties.

It is worth noting that since Force of attraction rule is not applicable, dividend is not deemed to arise to the PE of the company in source country always. This Article only permits dividends to be taxed as business profits “if they are paid in respect of holdings forming part of the assets of the PE or otherwise effectively connected with that PE.”

What is effectively connected has not been defined in the UN Model Convention. However, a particular location will constitute a PE only if business operations are carried on therein. Mere recording of shareholding in books of accounts of the PE without any business operation does not mean “effectively connected”.

According to Klaus Vogel, the term ‘Effectively Connected’ means the right giving rise to dividends

- Must form part of the assets of the PE;
- Must enhance the economic strength of the PE;
- Claim must be connected in form and substance; and
- Something really connected rather than legally connected.

The OECD Commentary states that the “economic” ownership of a holding means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the dividends attributable to the ownership of the holding and potential exposure to gains or losses from the appreciation or depreciation of the holding).

For E.g. Citibank USA has a branch in India which advances a loan to Indian Co. against security of shares. Therefore, shares are held by Citibank India and it receives dividend. i.e. the PE has economic ownership to exploit the asset. Such dividend shall be “effectively connected” with the PE in India and hence, taxed as Business Income.

10.2.5. Article 10(5): Extraterritorial taxation of dividend

“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 in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State”.

The provisions of OECD Model are similar to provisions of UN Model. However, OECD Model does not refer to ‘Fixed base’. It covers only PE situation.

As per above article, Source Country should not tax the dividend distributed by non-resident company to shareholders merely because such non-resident company derives its corporate profit that originated in Source Country.

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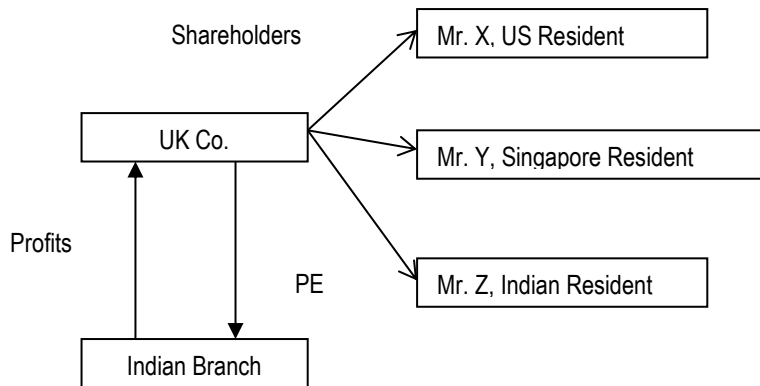
To say, this article prohibits the right of Country A to tax the dividend paid by a Company in Country B to its shareholders even though such dividend is paid out of profit arising / accruing in Country A except;

- (a) Dividend is distributed to shareholders of Country A;
- (b) Dividend is effectively connected with PE of the company in Country A.

In this way, article 10(5) prohibits such 'extraterritoriality' with respect to taxation of dividend.

Further, this article also prohibits Country of source from taxing of undistributed profits of a company resident of other Country even if the profits were wholly, mainly or partly derived from sources within Country of source.

For e.g. A UK Co. has a branch in India carrying out business operations in India. All its profits are attributable to that Indian branch. UK Co. declares dividend out of the profits accruing in India. In such case, India cannot tax such dividends paid to foreign shareholders (non-residents) unless it is paid to a shareholder who is a resident of India.



10.2.6. Deemed Dividend in India and Article 10

As already stated above in Para 2.3, as per provisions of section 2(22)(e) of the ITA, dividend includes "any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) made after the 31st day of May, 1987, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern) or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits;"

In order to prevent camouflaging of dividend in various ways such as loans and advances, the Finance Act, 2018 has provided that with effect from 1 April, 2018, DDT at the rate of 30% (without grossing up) shall be levied on deemed dividend referred to in section 2(22)(e) of the ITA. It has also widened the scope of the term 'accumulated profits' for the purpose of deemed dividend by inserting an Explanation 2A to section 2(22) to provide that in the case of an amalgamated company, the accumulated profits, whether capitalised or not, or loss, as the case may be, shall be increased by the accumulated profits, whether capitalised or not, of the amalgamating company on the date of amalgamation. Further, such deemed dividend subjected to DDT shall be exempt in the hands of the recipient shareholder.

Section 2(22)(e) is applicable to domestic as well as foreign companies. Therefore, sum paid by foreign company to a resident shareholder can be held as dividend. Similarly, the section does not distinguish between resident or non-resident shareholder. Therefore, prior to the amendment by the Finance Act, 2018 levying DDT on deemed dividend, deemed dividend could be taxed in India in the hands of non-resident shareholders as well.

Therefore, a question may arise whether deemed dividend under the ITA will be treated as a dividend as per the Article 10 of the tax treaty and whether the same amounts to other corporate rights.

Article 10(3) of the UN Model Convention states that “...income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident”.

In the case of *Rajiv Makhija vs DDIT, New Delhi, ITA No. 3148/Del/2008 pronounced on 25.09.2009* wherein the facts were that the assessee, a resident of Canada, was a Director of an Indian Company holding 90% of the shares of the Company. The company had advanced a loan to the assessee, which according to the Assessing Officer was liable to be taxed as deemed dividend under section 2(22)(e) of the ITA. However, the Hon'ble Tribunal relied on the Supreme Court decision in the case of *P.V.A.L Kulandagan Chettiar 267 ITR 654* wherein it was held that where tax liability is imposed by the Act, the DTAA may be resorted to either to reduce the tax liability or altogether avoid the tax liability and in case of any conflict between the provisions of the Act and the DTAA, the provisions of DTAA being more beneficial to the assessee, will prevail. In the instant case, the Tribunal held that as per Article 10 of the DTAA entered between India and Canada, deemed income in the form of deemed dividend cannot be brought into the tax net.

Since loan or advance does not amount to corporate rights, a view can be taken that deemed dividend u/s 2(22)(e) cannot be extended to Article 10 of the treaty.

The above discussion would be academic since post amendment by the Finance Act, 2018, deemed dividend subjected to DDT under section 115-O, shall be exempt in the hands of the recipient shareholder.

Further, a reference may be drawn to the CBDT Circular No. 4/2015 (F No. 500/17/2015-FT&TR-IV) dated 26.03.2015, wherein clarification to explanation 5 to Section 9(1)(i) is made. Explanation 5 states that “For the removal of doubts, it is hereby clarified that an asset or a

capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India".

There were apprehensions about the applicability of the said Explanation to the transactions not resulting in any transfer, directly or indirectly of assets situated in India. It had been pointed out that such an extended application of the provisions of the Explanation may result in taxation of dividend income declared by a foreign company outside India. Therefore, the CBDT has clarified that "*Declaration of dividend by such a foreign company outside India does not have the effect of transfer of any underlying assets located in India. It is therefore, clarified that the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets situated in India would not be deemed to be income accruing or arising in India by virtue of the provisions of Explanation 5 to section 9(1)(i) of the Act.*"

10.2.7. Provisions of Section 115BBD, Section 115-O and Section 80M

As per the provisions of Section 115BBD of ITA;

"(1) Where the total income of an assessee, being an Indian company, includes any income by way of dividends declared, distributed or paid by a specified foreign company, the income-tax payable shall be the aggregate of—

- (a) the amount of income-tax calculated on the income by way of such dividends, at the rate of fifteen per cent; and
- (b) the amount of income-tax with which the assessee would have been chargeable had its total income been reduced by the aforesaid income by way of dividends.

(2) Notwithstanding anything contained in this Act, no deduction in respect of any expenditure or allowance shall be allowed to the assessee under any provision of this Act in computing its income by way of dividends referred to in sub-section (1).

(3) In this section,—

- (i) "dividends" shall have the same meaning as is given to "dividend" in clause (22) of section 2 but shall not include sub-clause (e) thereof;
- (ii) "*specified foreign company*" means a foreign company in which the Indian company holds twenty-six per cent or more in nominal value of the equity share capital of the company."

Therefore, Section 115BBD provides for taxation of gross dividends received by an Indian company from a specified foreign company (in which it has shareholding of 26% or more) at the rate of 15% if such dividend is included in the total income for the relevant year.

The above provision was introduced as an incentive for attracting repatriation of income earned by residents from investments made abroad.

Provisions of Section 115-O

(1) Notwithstanding anything contained in any other provision of this Act and subject to the provisions of this section, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of April, 2003 (*but on or before the 31st day of March, 2020¹⁵⁴*), whether out of current or accumulated profits shall be charged to additional income-tax (hereafter referred to as tax on distributed profits) at the rate of fifteen per cent. Provided that in respect of dividend referred to in sub-clause (e) of clause (22) of section 2, this sub-section shall have effect as if for the words "fifteen per cent", the words "thirty per cent" had been substituted. (1A) The amount referred to in sub-section (1) shall be reduced by,

[(i) the amount of dividend, if any, received by the domestic company during the financial year, if such dividend is received from its subsidiary and,—

- (a) where such subsidiary is a domestic company, the subsidiary has paid the tax which is payable under this section on such dividend; or
- (b) where such subsidiary is a foreign company, the tax is payable by the domestic company under section 115BBD on such dividend:

Provided that the same amount of dividend shall not be taken into account for reduction more than once;].....

Explanation.—For the purposes of this sub-section, a company shall be a subsidiary of another company, if such other company, holds more than half in nominal value of the equity share capital of the company.

.....

(4) The tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends and no further credit therefore shall be claimed by the company or by any other person in respect of the amount of tax so paid.

(5) No deduction under any other provision of this Act shall be allowed to the company or a shareholder in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon....

Provisions of Section 80M¹⁵⁵

Deduction in respect of certain inter-corporate dividends

(1) Where the gross total income of a domestic company in any previous year includes any income by way of dividends from any other domestic company or a foreign company or a

¹⁵⁴ Italicised words inserted by Finance Act 2020

¹⁵⁵ Inserted by Finance Act 2020

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business trust, there shall, in accordance with and subject to the provisions of this section, be allowed in computing the total income of such domestic company, a deduction of an amount equal to so much of the amount of income by way of dividends received from such other domestic company or foreign company or business trust as does not exceed the amount of dividend distributed by it on or before the due date.

(2) Where any deduction, in respect of the amount of dividend distributed by the domestic company, has been allowed under sub-section (1) in any previous year, no deduction shall be allowed in respect of such amount in any other previous year.

Explanation.— For the purposes of this section, the expression "due date" means the date one month prior to the date for furnishing the return of income under sub-section (1) of section 139.

Therefore, in respect of dividends declared, distributed or paid prior to 31 March 2020, section 115-O provides that the tax base for DDT (i.e. the dividend payable in case of a company) is to be reduced by an amount of dividend received from its subsidiary (which is also an Indian Company) if such subsidiary has paid the DDT which is payable on such dividend. This ensures removal of cascading effect where dividend has been received from an Indian subsidiary. Similarly, section 115-O has been amended whereby the tax on dividends received from the foreign subsidiary is paid under section 115BBD by the holding domestic company then, any dividend distributed by the holding company in the same year, to the extent of such dividends, shall not be subject to DDT under section 115-O.

Post abolition of DDT regime by Finance Act 2020 and insertion of Section 80M, any dividend declared, distributed or paid after 1 April 2020, the tax incidence has been shifted from payer to the recipients of dividend.

For e.g.

Fig. in INR

Particulars	DDT Regime (Prior to 1 April 2020)	Post 1 April 2020 (Classical System)	Normal (115BBD not applicable)
Dividend Received from Foreign Subsidiary Company (FCo.)	60,00,000	60,00,000	60,00,000
Dividend to be distributed by the Indian Company	1,00,00,000	1,00,00,000	1,00,00,000
Less: Dividend Received from FCo.	60,00,000	60,00,000	NIL
Dividend on which DDT is payable	40,00,000	Not Applicable	1,00,00,000
DDT payable @ 20.358%	8,14,320	Not Applicable	20,35,800
Tax paid u/s 115BBD by the Domestic Co. on Dividend received from	9,00,000	NIL	20,00,000

FCo. @ 15% or at normal rates applicable say 30%			
Total tax Paid by I CO	17,14,320	NIL	29,35,800
Tax Payable by Shareholders of I Co	Nil or tax as per Section 115BBDA, if applicable	Tax payable as per normal rates applicable	Nil or tax as per Section 115BBDA, if applicable

A question may arise whether the benefit of DDT paid in India can be availed as a tax credit.

A reference can be made to the case of *Godrej & Boyce Mfg Co. Ltd v DCIT [2017] 394 ITR 449 (SC)* wherein the Supreme Court held that sub-sections (4) and (5) of section 115-O of the Act make it very clear that further benefit of such payments (DDT) cannot be claimed either by the dividend paying company or by the recipient shareholder. Therefore, credit for DDT cannot be availed.

Further, article 10(2) provides that “this paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid”. Therefore, credit for DDT paid is not available to the foreign shareholders in their home country. However, credit for DDT can be availed if the Resident State considers DDT as income-tax or underlying tax as per its domestic law.

In this regard, a reference can be drawn to the provisions of Article 25 Relief from Double Taxation of India-USA DTAA wherein it is stated that *“In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income—*

- (a) *the income-tax paid to India by or on behalf of such citizen or resident; and*
- (b) *in the case of a United States Company owning at least 10 per cent of the voting stock of a company which is a resident of India and from which the United States company receives dividends, the income-tax paid to India by or on behalf of the distributing company with respect to the profits out of which the dividend is paid.”*

Therefore, since the India-US DTAA has provisions for underlying tax credit, it may be possible for a US investor in India to claim credit for the DDT suffered under Section 115O of the Act, on the dividends received from its Indian investments. However, in case of DTAA's where there is no underlying tax credit available, the issue on whether ordinary foreign tax credit would be available for Dividend Distribution Tax or not is not free from doubt.

India, however, does not have a tax system which allows credit of the underlying taxes paid by the overseas subsidiaries of Indian corporations. India generally taxes dividend without giving credit for any underlying taxes. However, there are certain exceptions such as the treaties signed with Mauritius and Singapore, where credit is provided for the underlying taxes paid.

Article 25 Avoidance of Double Taxation of India-Singapore DTAA states that;

"2. Where a resident of India derives income which, in accordance with the provisions of this Agreement, may be taxed in Singapore, India shall allow as a deduction from the tax on the income of that resident an amount equal to the Singapore tax paid, whether directly or by deduction. Where the income is a dividend paid by a company which is a resident of Singapore to a company which is a resident of India and which owns directly or indirectly not less than 25 per cent of the share capital of the company paying the dividend, the deduction shall take into account the Singapore tax paid in respect of the profits out of which the dividend is paid. Such deduction in either case shall not, however, exceed that part of the tax (as computed before the deduction is given) which is attributable to the income which may be taxed in Singapore."

10.2.8. Treaty Comparison

Here is a list of Exceptional Treaties that India has signed

Article 10(1)

Australia	Greece	Netherlands	Egypt
Dividend paid by a Co. which is a resident of one of the Contracting States for the purposes of its tax, being dividends to which a resident of the other Contracting State is beneficially entitled may be taxed in that other State	Dividend paid by a Co. which is a resident of one of the territories to a resident of other territory may be taxed only in the first mentioned territory.	Dividend paid by a Co. which is a resident of one of the States to a resident of other State may be taxed in that other State	Dividend paid by a Co. which is a resident of India to a resident of other Contracting State may be taxed in India Dividends paid by a company which is a resident of the United Arab Republic to a resident of India may be taxed in the United Arab Republic. But such dividends shall only be subject to the tax on income derived from movable capital, the defence tax, the national security tax and the supplementary taxes (which taxes shall be deducted at the source). If paid to a natural person, the general income-tax levied on the net total income may also be imposed. Dividends paid shall be deducted from the amount of the distributing company's taxable income or profits subject to the tax chargeable

Australia	Greece	Netherlands	Egypt
			in respect of its industrial and commercial profits if such dividends are distributed out of the taxable profits of the same taxable year but not distributed out of the Accumulated reserves or other assets.

Article 10(2)

Australia and Sri Lanka	Sri Lanka	Canada	Italy	Malta
Such dividends may also be taxed in the Contracting State of which the company paying the dividend is a resident for the purpose of its tax, and according to the law of that State, but the tax so charged shall not exceed 15% of the gross amount of dividend.	...such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed 7.5% of the gross amount of the dividends.....	...such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed : (a) 15 per cent of the gross amount of the dividends if the beneficial	... such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the recipient is the beneficial owner of the dividends, the tax so charged shall not exceed : (a) 15 per cent of the gross amount of the dividends if the beneficial owner is a company which owns at	..such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but: (a) if the dividends are paid by a company that is a resident of India to a resident of Malta who is the beneficial owner thereof, the tax charged by India shall not exceed 10

Australia and Sri Lanka	Sri Lanka	Canada	Italy	Malta
		<p>owner is a company which controls directly or indirectly at least 10 per cent of the voting power in the company paying the dividends;</p> <p>(b) 25 per cent of the gross amount of the dividends in all other cases.</p>	<p>least 10 per cent of the shares of the company paying the dividends ;</p> <p>(b) 25 per cent of the gross amount of the dividends in all other cases.</p>	<p>per cent of the gross amount of the dividends;</p> <p>(b) if the dividends are paid by a company that is a resident of Malta to a resident of India who is the beneficial owner thereof, the tax charged by Malta on the gross amount of the dividends shall not exceed that Malta tax chargeable on the profits out of which the dividends are paid.</p>

Definition of term 'dividend'

Australia	Canada	Libyan Arab Jamahiriya
The term dividends in this Article means income from shares and other income which is subjected to same taxation treatment as income from shares by the laws of the Contracting State of which the Company making the distribution is a resident for the purposes of its tax	The term dividends in this Article means income from shares and other rights not being debt claims, participating in profits as well as income assimilated to the income from shares by the taxation law of the State of which the Company making the distribution is a resident	The term 'dividends' shall be defined in accordance with the law of the Contracting State in which the company in question is a resident.

Article 10(5)

Australia	Tanzania & Zambia
Dividends paid by a Company which is a resident of one of the Contracting States, being dividends to which a person who is not a resident of the Other contracting State is beneficially entitled, shall be exempt from tax in that Other State except in so far as the holding in respect of which the dividends are paid is effectively connected with the permanent establishment or fixed base situated in that other State, provided that this para shall not apply in relation to dividends paid by any company which is a resident of other Contracting State for the purposes of tax and which is also a resident of India for the purposes of Indian tax law	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 to persons who are not resident of that other State or subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consists wholly or partly of profits or income arising in such other State.

10.2.9 Some of the DTAA's have a 'Most Favoured Nation' (MFN) clause pursuant to which a restrictive meaning is accorded. E.g.in the case of DTAA with Netherlands has the following Protocol signed:

"PROTOCOL

At the moment of signing the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, this day concluded between the Kingdom of the Netherlands and the Republic of India, the undersigned have agreed that the following provisions shall form an integral part of the Convention.

IV. Ad Articles 10, 11 and 12

1. Where tax has been levied at source in excess of the amount of tax chargeable under the provisions of Article 10, 11 or 12, applications for the refund of the excess amount of tax have to be lodged with the competent authority of the State having levied the tax, within a period of three years after the expiration of the calendar year in which the tax has been levied.

2. If after the signature of this convention under any Convention or Agreement between India and a third State which is a member of the OECD India should limit its taxation at source on dividends, interests, royalties, fees for technical services or payments for the use of equipment to a rate lower or a scope more restricted than the rate or scope provided for in this Convention on the said items of income, then as from the date on which the relevant Indian Convention or Agreement enters into force the same rate or scope as provided for in that Convention or Agreement on the said items of income shall also apply under this Convention."

As per the Protocol, if India enters into a DTAA with another OECD country limiting its taxation on dividends say at a lower rate than that prescribed in the India Netherlands Treaty, such lower rate would apply for India Netherlands Treaty also. Similar benefit would be extended in respect of interest and Fees for Technical services and for payment in respect of use of equipment. So far as the latter two are concerned the benefit will also cover scope of taxation.

There were issues with regard to implementation of MFN clause i.e. Whether the MFN clause would be applicable where the third countries were not members of the OECD at the time of entry into force of their DTAAs and whether a separate notification was required to import such benefits into the DTAAs with the MFN Countries.

Recently, the Supreme Court in its ruling [*Assessing Officer v. M/s. Nestle SA. Civil Appeal No(s). 1420 of 2023, Decision dated 19 October 2023*] laid down that a separate notification, under section 90(1) of the Act, is mandatory to give effect to any DTAA or its protocol that effectively changes the existing provisions of the law. The SC's reasoning was that although the Union has exclusive power to enter into DTAAs, the Parliament has the exclusive power to give effect to such DTAAs by enacting them into law. Unless such effect is given, the DTAAs are not, by their own force, binding upon Indian nationals. The Parliament must step in when such DTAAs affect the rights of citizens or modify the law of India. No legislation is required only when citizens' rights are unaffected, or the law is not modified.

The SC further observed that unilateral orders and decrees passed by the governments of other countries cannot be relied upon to interpret DTAAs as the manner of assimilation of DTAAs in other countries is greatly different from the manner of assimilation in India, where legislative action is required. In India, the general practice is to give benefit of the MFN clause post the issuance of a separate notification under section 90. Such a practice cannot be undermined.

On the issue of whether the third country needs to be a member of the OECD at the time of its DTAA coming into force, the SC, in its ruling, clarified that the phrase "is a member" implies present significance, which means that the third country must be a member of the OECD when

it enters into a DTAA with India, for the earlier DTAA beneficiary to be able to claim applicability of the MFN clause.

Thus, the Hon'ble SC upheld the stand of Revenue, which was clarified vide circular dated 03.02.2022 wherein it clarified that any unilateral publication of a Country does not represent shared understanding of the treaty partners. India further clarified that for applicability of the MFN clause, the third State has to be an OECD member State on the date of conclusion of DTAA with India. Application of concessional rates/restricted scope from the date of entry into force of the DTAA with the third State and not from the date the third State becomes member of the OECD:

Thus, it was clarified that the applicability of the MFN clause and benefit of the lower rate or restricted scope of source taxation rights in relation to certain items of income (such as dividends, interest income, royalties, Fees for Technical Services, etc.) provided in India's DTAAs with the third States will be available to the first (OECD) State only when all the following conditions are met:

- (i) The second treaty (with the third State) is entered into after the signature/ Entry into Force (depending upon the language of the MFN clause) of the treaty between India and the first State;
- (ii) The second treaty is entered into between India and a State which is a member of the OECD at the time of signing the treaty with it;
- (iii) India limits its taxing rights in the second treaty in relation to rate or scope of taxation in respect of the relevant items of income; and
- (iv) A separate notification has been issued by India, importing the benefits of the second treaty into the treaty with the first State, as required by the provisions of sub-section (1) of Section 90 of the Income Tax Act, 1961.

If all the conditions enumerated in Paragraph (i) to (iv) are satisfied, then the lower rate or restricted scope in the treaty with the third State would be imported into the treaty with an OECD State having MFN clause from the date as per the provisions of the MFN clause in the DTAA, after following the due procedure under the Indian tax law.

10.2.10 Case Study

(a) Mr. X is a Resident of India who has invested in equity shares of a M/s ABC Pte Ltd, a Company incorporated under the laws of Singapore. The Company in Singapore declares dividend @ 10%. As per the tax laws of Singapore, dividend paid to non-residents does not attract withholding tax provisions. What is the tax liability of the Mr. X in India, being a Resident as per the Indian tax laws?

Answer:

As per the ITA, a Resident Indian is liable to tax in India on his global income. Therefore, dividend received from a foreign company (M/s ABC Pte Ltd) shall be liable to tax in India at the tax rates applicable to him (in his case, as per income tax slab). It may be noted that benefit of

treaty provisions may not be available to Mr. X since there was no withholding of taxes in Singapore.

(b) Ind Co. declares dividend @ 10% on its profits and pays DDT thereon @ 15% in India. Dividend is paid to Mr. X, a resident of USA. As per US tax laws, worldwide income shall be taxed in hands of Mr. X. The said dividend income is a taxable income for him in USA. Whether he will get credit for DDT paid by Ind Co. in India while computing his tax liability US?

Answer:

Under the DTAA, tax credit is typically available for tax on income (i.e. income-tax) and/ or for tax on the profits of the company from which dividend is declared (i.e. Underlying Tax Credit). Therefore, tax credit on DDT is per se not available under the DTAA since in case of DDT, tax is paid by the Indian company and the said income is fully exempt in the hands of the shareholder. Therefore, credit of DDT may generally not be available unless the domestic law in the country of residence of the shareholder (USA) provides for it. However, in the specific case of USA, as per the Article 25, it may be allowed as a tax credit.

10.2.11. Some recent rulings

SGS India (P.) Ltd. (2017) 83 taxmann.com 163 (Mum ITAT)

The assessee, an Indian company, was a wholly owned subsidiary of a Swiss company. It had paid dividend during the year and had paid tax at the rate prescribed u/s 115-O i.e.15%. It was submitted by the assessee that as per Article 10 of the India-Switzerland DTAA, tax on dividend distributed should have been restricted to maximum of 10% instead of the rate prescribed under section 115-O. The Tribunal held that on a plain reading of the provisions of section 115-O, it appears that the DDT is a liability of the domestic company declaring dividend and not liability of the shareholder receiving such dividend income, whereas, careful reading of Article 10 of the DTAA prima facie gives an impression that it speaks of taxability of the dividend at the hands of the recipient of such dividend which is a resident of the other contracting state. The Tribunal thus remanded the matter for examination of whether the benefit of DTAA can be extended to the DDT paid/payable by the assessee keeping in perspective the provisions contained under section 115-O vis a vis Article 10 of the DTAA.

Tripti Trading & Investment Ltd. (2017) 80 taxmann.com 287 (SC)

Following the Apex Court's decision in the case of Turquoise Investment & Finance Ltd, it was held that dividend income received by the assessee from a foreign country was exempt from taxation in terms of the India-Malaysia DTAA.

11. Article 11–Interest

We shall now deal with the provisions of the Taxation of Interest as per Article 11 of UN Model Convention.

Interest, which, like dividends, constitutes income from movable capital may be paid to individual savers who have deposits with banks or hold savings certificates, to individual investors who have purchased bonds, to individual suppliers or trading companies selling on a deferred

payment basis, to financial institutions which have granted loans or to institutional investors which hold bonds or debentures. Interest may also be paid on loans between associated enterprises.

At the domestic level, interest is usually deductible in calculating profits. Any tax on interest is paid by the beneficiary unless a special contract provides that it should be paid by the payer of the interest. Contrary to what occurs in the case of dividends, interest is not liable to taxation in the hands of both the beneficiary and the payer. If the latter is obliged to withhold a certain portion of the interest as a tax, the amount withheld represents an advance on the tax to which the beneficiary will be liable on his aggregate income or profits for the fiscal year, and the beneficiary can deduct this amount from the tax due from him and obtain reimbursement of any sum by which the amount withheld exceeds the tax finally payable. This mechanism prevents the beneficiary from being taxed twice on the same interest.

The term 'interest' and the scope of Article 11 is determined by the benefit received where the amount to be taxed represents the payment for a transfer of the use of capital. Interest is taxed only in the hands of the lender, and borrower generally gets a deduction for the interest paid and thus unlike dividends, interest does not suffer economic double taxation.

11.1. Article 11 (1): Taxability of interest in Resident Country

"Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State."

Therefore, the Resident state can always tax the income unless DTAA prohibits it. Even without this clause, the Resident Country could tax interest.

However, this Article does not apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State.

The 2 important phrases used in this article are "Paid" and "may be taxed".

The term "Paid" should not be restricted to physical payment in cash as it might include performance in kind or set off amounts. The term "May be taxed" gives right to the Resident state to tax the interest income.

11.2. Article 11(2): Taxability of interest in Source Country

"However, interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation."

Article 11(2) of OECD Model is similar to Article 11(2) of UN Model. However, OECD Model specifies the percentage at 10%.

Thus, it may be seen that interest is taxed in both the States, the Source State as well as the Resident State. This Article provides to the Source Country a limited right to tax dividend as per its domestic laws at concessional rate. The benefit of concessional tax rate is given subject to fulfilment of certain conditions. Accordingly, the recipient of interest should be:

- a) a beneficial owner of Interest; and
- b) a resident of other Country.

Both the UN Model as well as OECD Model provide for a division or sharing of taxing rights in respect of interest income between the Source Country and the Residence Country. Thus, it does not provide for an exclusive right of taxation in favour of the residence country. The Source Country has the primary right of taxing cross border interest on gross basis under Article 11(2) but it will tax the interest in accordance with its own domestic tax laws. The Country of residence has a right to tax cross border interest in terms of provisions of Article 11(1). The taxation by the Country of residence will also depend upon its domestic laws along with the provisions of Article 23 (method of dealing with double taxation), and on the basis of which it may either exempt the interest altogether or include it in the lenders income and give credit for the taxes paid / deducted in the Source Country.

The concept of "may also be taxed" and "beneficial owner" is already explained above vide para 2.2.1 and 2.2.3 respectively.

It may be pertinent to note that India taxes interest payments made to non-residents at source, by way of withholding tax payments.

11.3. Article 11(3): Meaning of the term interest

"The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

This is an exhaustive definition of interest and covers all kinds of income which may be regarded as interest in various domestic tax laws. Further, it may be noted that no reference has been drawn to the domestic tax laws while defining the term interest (as opposed to the article on dividends) so as to avoid any possible dispute and uncertainty about the import of 'interest' which may arise with the change in domestic law.

The definition of interest in all the three models viz. OECD, UN and US Model is similar in that it essentially means income from debt claims of every kind. The OECD commentary (under paragraph 21.1 of Article 11) states that *"the definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of non-traditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the definition will apply to the extent that a loan is considered to exist under a "substance over form" rule, an "abuse of rights" principle, or any similar doctrine. The second*

sentence of Paragraph 3, excludes from the definition of interest the penalty charges for late payment but Contracting States are free to omit this sentence and treat penalty charges as interest in their bilateral convention....”

Interest charged by banks or financial institutions or payable on money borrowed for purchase of either machinery or goods or raw materials abroad, are not taxable in many developing countries. Exemption is provided to encourage industrial development.

As per the OECD Commentary (Para 18 of Article 11), the term “Debt claim of every kind” is very wide and it includes cash deposits, security in form of money, Govt. securities, bonds & debentures. It is recognised, on the one hand, that mortgage interest comes within the category of income from movable capital (revenus de capitaux mobiliers), even though certain countries assimilate it to income from immovable property. Debt claims having right to participate in debtor's profits are regarded as loans if the contract by its general character clearly evidences a loan at interest. The debt claim further includes premiums and prizes attached to above.

Whether Interest or Dividend?

- Interest on participating bonds or on convertible bonds should not be considered as dividend until such time the bonds are actually converted into shares. But the interest on such bonds should be considered as dividend if the loan effectively shares the risks run by the debtor company.
- In certain cases it becomes difficult to distinguish between dividend and interest (such as in cases of presumed thin capitalization) which may result in overlapping. It can be said that the term “interest” as used in Article 11 does not include items of income which are dealt with under Article 10.
- The commentary of Klaus Vogel on Double Taxation Conventions states that interest is no more than the remuneration received for making capital available subject to repayment, and does not include profits from providing funds in cases where the provider accepts the hazards of the borrower's business. This distinguishes interest from business profits within the meaning of Article 7 – to the extent that such profits, too, are made by providing capital – and from dividends within the meaning of Article 10. On the other hand the creditor's general hazard i.e. the risk of not being able to enforce this debt-claim on account of the borrowers insolvency or of the debt being irrecoverable, do not by themselves involve the lender in the hazards of the borrowers business.
- As a rule, ‘interest’ within the meaning of Article 11 also includes the remuneration paid by a company to any shareholders or members for the latter having made capital available for use by the company - as distinct from such shareholders’ or members’ contribution under the articles or deed of association. Since interest unlike dividends, is generally allowed to be deducted from the company's profit before corporation tax and since, moreover, taxation of interest in the State of source is more beneficial than that of dividends, it is likely that the company will prefer such borrowings to increasing its shareholders’ contributions. In the meantime, various States have passed legislation

designed to prevent such devices from resulting in tax avoidance, and particularly envisaging that the interest paid be treated as a dividend in cases where there appears to be under capitalization or thin capitalization. The Finance Act, 2017 has inserted a new section 94B in line with BEPS Action Item 4 ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments") which provides that where an Indian company or an Indian PE of a foreign company, being the borrower incurs any expenditure by way of interest or of similar nature exceeding one crore rupees which is deductible in computing income chargeable under the head "Profits and gains of business or profession" in respect of any debt issued by a non-resident, being an associated enterprise of such borrower, the deduction shall be limited to 30% of EBITDA(earnings before interest, taxes, depreciation and amortisation) or interest paid, whichever is less.

For the purpose of determining debt issued by the non-resident, the funds borrowed from a non-associated lender shall also be deemed to be borrowed from an associated enterprise if such borrowing is based on an implicit or explicit guarantee of an associated enterprise.

The Finance Minister's budget speech stated that the provision is being introduced in order to address the issue of thin capitalisation.

Some of the financial instruments combine the characteristics of equity, debt, forward purchase contracts, options and other derivatives. These instruments are used mainly for the purpose of tax planning as these instruments are tax deductible in one jurisdiction and equity in another.

- In the case of *NA General Partnership & Subsidiaries, Iberdrola Renewables Holdings, Inc. & Subsidiaries vs. Commissioner of Internal Revenue [2012] 22 taxmann.com 245 (TC-US)*, the following principles were laid down for determining whether the advance received from the parent company is more akin to debt or equity.
 - (i) Type of certificate parties used to evidence the advance - The issuance of a debt instrument (such as a promissory note) supports the characterization of an instrument as debt. Issuance of an equity instrument (such as a stock certificate) supports an equity characterization.
 - (ii) Fixed Maturity Date - Presence of a fixed maturity date for repayment supports a debt characterization. Absence of fixed maturity date indicates that repayment of the advance depends on the success of the business and favours an equity characterization.
 - (iii) Source of Payment – Advance is characterized as debt when repayments are not contingent on earnings. An equity investment is indicated where repayment depends on earnings or is to come from a restricted source. In such a case, the purported lender acts "as a classic capital investor hoping to make a profit, not as a creditor expecting to be repaid regardless of the company's success or failure."
 - (iv) Right to enforce payment of principal and interest - A definite obligation to repay is evidence of debt. A lack of security for repayment of purported debt generally

supports an equity characterization.

- (v) Participation in management (whether the person making an advance increases his or her management rights) - If no increase in participation rights, this indicates debt. Increased right to participate in management resulting from an advance contributes to an equity finding.
- (vi) Status equal to or inferior to that of regular corporate creditors - With holding companies, any debt issued is necessarily subordinated to the creditors of its operating company. Accordingly, this type of subordination is to be expected and does not in and of itself cast doubt on the legitimacy of debt issued by a holding company. Subordinating a purported creditor's right to repayment to that of other creditors supports an equity characterization. Nevertheless, subordination does not necessarily indicate equity when an advance is given priority over the claims of shareholders.
- (vii) Parties' Intent - As evidenced by documentation and book entries- whether the parties intended the advance to be debt or equity.
- (viii) Inadequate Capitalization (sufficiency of the purported debtor's capitalization) - Inadequate capitalization indicates that an advance is equity.
- (ix) Identity of interest between creditor and sole shareholder (whether the advance was made by a sole shareholder) - A sole shareholder's advance is more likely committed to the risk of the business than an advance from a creditor who is not a shareholder.
- (x) Interest payments - The presence of an obligation to pay interest and actual interest payments indicate an advance is debt. Lack of interest payments indicates equity.
- (xi) Ability to obtain comparable loans from outside lending institutions - Evidence that the purported debtor could have obtained loans from outside sources points toward debt. Evidence that the taxpayer could not obtain loans from independent sources points toward equity.

The United States Tax Court held that all the above factors must be evaluated and no single overriding factor should be relied on for determining whether advance is equity or debt. If on such evaluation, it is found that the advance was more akin to debt than equity, payments of interest made with respect to advance are allowable as deduction.

- In the case of *Hewlett-Packard Company and Consolidated Subsidiaries vs. Commissioner of Internal Revenue* [2012] 21 *taxmann.com* 252 (TC-US), the petitioner purchased interest in a foreign corporation, he also purchased a put option from another shareholder ('Q') to sell his interest to him on exercise date at a Fair Market Value prevailing on that date. Such put agreement was referenced in the shareholders' agreement, to which the foreign corporation was a party. The foreign corporation's business activities were effectively limited by its articles of incorporation, and such

shareholders agreement, to purchase the interest from 'Q' only. The shareholders agreement also afforded the Petitioner the exclusive authority to assemble a shareholders meeting upon the occurrence of certain events at which the shareholders could:

- (a) cause the foreign corporation to reduce its capital in order to redeem or repurchase Petitioner's shares, or
- (b) cause the foreign corporation to dissolve.

In the light of above facts, United States Tax Court held that Petitioner's investment in the foreign corporation is more appropriately characterized as a loan for Federal income tax purposes and Petitioner was not entitled to deduct a capital loss in connection with its exit from the transaction.

Meaning of Interest under the ITA

Interest is generally taken to mean remuneration or income from debt claims of every kind, income from investments, bonds or government securities and income from the purchase or sale of goods on credit.

As per section 2(28A) of the ITA, "interest means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized"

As per section 2 (28B) of the ITA "interest on securities" means,— (i) interest on any security of the Central Government or a State Government ; (ii) interest on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or Provincial Act"

The definition of interest as per UN & OECD Model Convention is more or less in line with the definition of interest as per ITA.

11.4. Article 11(4): Permanent Establishment Situation

"The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply."

The Article 11(4) of OECD Model is similar to provisions of UN Model, with two modifications. First, the UN Model Convention refers to a fixed base as well as a permanent establishment. Second, the OECD version only applies if the obligation on which the interest is paid is effectively connected with the permanent establishment. However, broadly speaking there would not be material difference in treatment of this Article under both the models.

This article states that article 11 (1) & (2) will not apply if the beneficial owner of the interest i.e. the lender has a PE in the interest Source state which carries on business and debt claim is effectively connected with that source state PE. In such case Article 7 –Business Income or Article 14- Independent Personal Services will apply.

For E.g. Citibank, USA has a branch in India. A Ltd, an Indian Co. has taken a loan from Citibank, India branch and is paying interest to it. This interest shall be taxable as business profits in the hands of Citibank, USA in India as it is effectively connected with the PE in India.

Reference may be made to a ruling of the Chennai Tribunal in Hyundai Motor India Ltd (2017) 187 TTJ 97 (Chennai ITAT). In the instant case, the assessee had borrowed monies from Standard Chartered Bank Mauritius and HSBC Mauritius on which it paid interest. The Tribunal rejected the Revenue's stand that the said interest income was taxable in India since signing of the agreements was done in Chennai branch in India and further as the Indian affiliates stood as guarantors to the borrowings by the assessee. The Tribunal clarified that the mere presence of affiliates in India, and the fact that some role was played by the affiliates, doesn't lead to a conclusion that Standard Chartered Mauritius and HSBC Mauritius had PE in India. It also clarified that mere occasional use of the office of Indian affiliate cannot result in PE. It observed that none of the tests laid down in Article 5(1) of India-Mauritius DTAA for constitution of fixed place PE were satisfied. The ITAT thus granted treaty protection under Article 11(1) of the DTAA which provides for taxability of the interest in Mauritius.

The UN model convention, unlike OECD, adopts a limited force of attraction rule in Article 7. i.e. When an enterprise sets-up a PE in another country, it brings itself within the fiscal jurisdiction of that another country to such a degree that such another country can tax all profits that the enterprise derives from that country - whether through the PE or not. Therefore, under the 'force of attraction rule' mere existence of PE in another country leads all profits derived from that another country being treated as taxable in that another country. Due to limited force of attraction under UN model commentary dividends will be taxed only if the income is effectively connected with the PE. Thus, Dividends will be taxed as business income only if the recipient is the beneficial owner having a PE and the shareholding of Co. paying the dividend is effectively connected with the PE. Similarly, interest will be taxed as business income only if the recipient is a beneficial owner having a PE and such interest is effectively connected with the PE.

What is effectively connected is already dealt in Para 2.4 above.

11.5. Article 11(5): Extraterritorial taxation of interest

"Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."

This Article provides that where the interest is effectively connected to a permanent

establishment in the source country then the source country has the right to tax the same as business income in terms of Article 7, and the determination of the existence of the permanent establishment needs to be made on the basis of the provisions of Article 5. Paragraph 5 of Article 11 lays down the principle that the State of source of interest is the State of which the payer of the interest is a resident. However, it also provides an exception to this rule in the case of interest-bearing loans which have an economic link with the permanent establishment owned in the other Contracting States, by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, then the source of interest is in the Contracting State in which the permanent establishment/fixed base is situated irrespective of the place of residence of the owner of the permanent establishment/fixed base even when he resides in neither of the Contracting States. The existence of the nexus between the indebtedness and the needs of the permanent establishment/fixed base is the essential requirement for holding the state of location of permanent establishment/fixed base as the source of interest. The absence of the nexus will render this rule inapplicable.

For e.g. there is a UK Co. which has taken loan from a US Co. The UK Co. has a branch (which constitutes a PE) in India. The loan taken from US Co. is for the branch in India. Interest is paid by the UK Co. to the US Co. which is ultimately borne by the Branch in India. Therefore, in such a case, the interest arises in the state in which the PE is located i.e. India and hence India-US tax treaty will apply.

The OECD Commentary (Para 27 Article 11) has cited a few possible situations where the above principle laid down by Paragraph 5 of Article 11 can be examined:

- (a) The management of the PE has contracted a loan which it uses for the specific requirements of the PE; it shows it among its liabilities and pays the interest thereon directly to the creditor.
- (b) The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a PE situated in another country. The interest is serviced by the head office but is ultimately borne by the PE.
- (c) The loan is contracted by the head office of the enterprise and its proceeds are used for several PE's situated in different countries.

In cases (a) and (b) the conditions laid down in the second sentence of paragraph 5 are fulfilled, and the State where the PE is situated is to be regarded as the State where the interest arises. Case (c), however, falls outside the provisions of paragraph 5, the text of which precludes the attribution of more than one source to the same loan. Such a solution, moreover, would give rise to considerable administrative complications and make it impossible for lenders to calculate in advance the taxation that interest would attract. It is, however, open to two Contracting States to restrict the application of the final provision in paragraph 5 to case (a) or to extend it to case (c).

The commentary of Klaus Vogel on Double Taxation Conventions states that the debt in respect of which the interest is paid must have been incurred for the purposes of PE (or fixed base). The criterion of use of the loan for purposes of, and the bearing of interest by, the PE is a way

of designating an economic connection between the loan and the PE. This indicates a parallelism between these two criteria on the debtor's side and the phrase 'effectively connected' in the 'permanent establishment proviso' on the creditor's side. It is true that the liability will, as a rule, not be recognized as pertaining to a PE unless it is shown in the PE's balance sheet. But if the latter does not have a separate balance sheet – such as in the case of indirect determination of profits, or if the debt has been redeemed before the balance sheet date, the matter will have to be judged by application of economic criteria.

Therefore, it can be concluded that;

- If the PE borrows – Interest clearly arises in Source Country and is taxable
- If HO borrows specifically for the PE, funds are used for business of PE and Interest is borne by the PE. It is taxable in Source Country
- If HO borrows generally for all its worldwide PEs and subsidiaries. Some indirect interest cost is attributable to the PE. It does not arise in Source Country. Article 11 cannot apply.

11.6. Article 11(6): Arm's Length Condition

"Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."

This rule will operate where a special relationship prevails between the payer of interest and beneficial owner of the interest and the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. Here, Special Relationship means i) participation in management, control and capital (direct or indirect) and ii) relatives (relationship by blood or marriage). Therefore, benefits of article 11 for lower tax rates applies only to the arms' length interest.

The OECD Commentary (Para 35 Article 11) states that with regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11 it would be necessary as a minimum to remove the limiting phrase "having regard to the debt claim for which it is paid". If greater clarity of intent is felt appropriate, a phrase such as "for whatever reason" might be added after "exceeds".

Thus, such excess payment needs to be classified under the type of income to which its 'nature'

relates, in cases of disputes it will be necessary to resort to the mutual agreement procedure provided by the Convention.

For e.g. A subsidiary company in India pays interest @ 15% to the Holding Company in USA but interest @ 10% to another unrelated company in USA, the excess of 5% would be required to be scrutinised. The exact nature of excess amount has to be determined in order to categorize such income as dividend or other income under the domestic laws. Only the rate of interest can be adjusted and not the interest amount. Possibly Article 7, 10, 21 of the relevant tax treaty may apply.

Such excess interest payment could result in a transfer pricing adjustment. Additionally, as stated above, a new section 94B has been inserted w.e.f. 1 April 2018 for limiting interest deduction in the hands of an Indian company or an Indian PE of a foreign company, in relation to its borrowings from a non-resident associated enterprise.

In these cases State of Residence may not give tax credit of taxes paid in the Source State as tax paid on excess interest is not in accordance with the applicable DTAA.

There could be tax credit issue on account of conflict of the characterization of the debt as capital and vice versa. Resident state may not grant credit of taxes paid in source state on interest as according to them compensation derived is a dividend.

OECD recommends that in such a situation Resident State may accept the characterization of the Source State.

Further to above there could be issue of tax credit on account of time mismatch, difference in the accounting year etc, and these may be resolved in accordance with the OECD MC.

11.7. Whether the following would amount to interest (along with judicial precedents in support thereof)

11.7.1 Service Charges

Bank providing credit facilities to its card holders is different from debt created between lender and borrower. The service charges received from the credit card holders on overdue payment is not interest on loan and thus the amount due from card holders is not taxable as interest.

11.7.2 Interest Paid by branch to HO

The taxability of interest paid or received between the Indian branch (or Permanent Establishment) and its Head Office ('HO') or other overseas branches has been a matter of debate. The various positions which were adopted by the tax officers in this regard are as follows:

- (a) Interest paid by the permanent establishment is deductible while computing 'Income from business' and taxable at concessional rate prescribed under the Income-tax Act or applicable tax treaty in the hands of HO;
- (b) Interest paid by PE is payment to self, hence not deductible while computing 'Income from business' of the PE and not taxable in the hands of the HO; and

- (c) Interest paid by PE is payment to self, hence not deductible while computing 'Income from business' of the PE but taxable in the hands of the HO at either the concessional rate or at the rate applicable to foreign company.

A reference can be drawn to the decision of the Larger Special Bench of the Mumbai Tribunal in the case of *Sumitomo Mitsui Banking Corporation vs. DDIT [2012] 136 ITD 66 (MUM.)(SB)* which throws some light on the taxability of inter-bank loans and brings in much needed respite to foreign banks.

The Larger Bench's decision can be summarized as under:

- Interest paid to the HO by its Indian branch which constitutes its PE in India is though not deductible as expenditure under the domestic law being payment to self, the same is deductible while determining the profit attributable to the PE which is taxable in India as per the provisions of Article 7(2) and 7(3) of the applicable Tax Treaty;
- The interest paid by the Indian Branch to its HO / Offshore Branches is not income chargeable to tax in India as being payment to self which cannot give rise to income that is taxable in India as per the domestic tax law. Further, the tax implication under the tax treaty was not examined as interest is per se not taxable under the Act (domestic law).
- Separately, since the income is not chargeable to tax in India, provisions of section 195 are not attracted and there being no failure to deduct tax at source from the payment of interest by the PE, the interest is held allowable as deduction for the Indian Branch.

The decision of the Larger Special Bench has been rendered under the tax treaty between India-Japan and India-Belgium, which provide for specific deduction in respect of interest paid by Indian Branch of banking company to its HO. The applicability of this decision in the case of other tax treaties which do not provide for specific deduction would need to be examined.

Other relevant cases on this line are *Bank of Tokyo Mitsubishi UFJ Ltd. v. ADIT [2014] 49 taxmann.com 441 (Delhi - Trib.)*, *Deutsche Bank AG v. Asst. DIT [2014] 47 taxmann.com 378 (Mumbai - Trib.)* and *ADIT v. Mizuho Corporate Bank Ltd. [2014] 48 taxmann.com 104 (Mumbai - Trib.)*

It is pertinent to note the Circular No. 740 dated 17.04.1996 of the CBDT on "Taxability of interest remitted by branches of banks to the head office situated abroad, under the Foreign Currency Packing Credit Scheme of Reserve Bank of India". It deals with the requirement of deduction of tax at source from payment of interest by the Indian branch (PE) of a foreign company to its head office. The circular requires that the branch and the head office should be treated as separate entities for the purposes of taxation. It further provides that in case the relevant DTAA provides a lower rate of taxation, the same would be applicable for the purposes of deduction of tax by the Indian branch.

In the case of *ABN Amro Bank, N.V. vs. CIT [2012] 343 ITR 81 (HC Cal.)*, the assessee was a foreign company incorporated in Netherlands having its principal branch office in India. The said branch of the assessee in India remitted substantial funds to its head office as payment of interest. The two principal issues raised in the appeal were whether interest payment was to be

allowed as a deduction in computing the profits of the assessee's branch in India and whether in making such payment to the head office, the assessee's said branch was required to deduct tax at source under section 195 of the Act.

The Calcutta High Court held that as per section 90 of the Act, a more beneficial provision amongst the rival provisions in the tax treaty and the Act would apply to the assessee. It was also stated that Article 5(2) of the tax treaty defines 'permanent establishment', which includes branch and if it is further read with article 7, the permanent establishment or the branch is to be treated as a separate unit. Article 7(2) specifically states that it is to be considered as a distinct and separate enterprise and its profits are to be so computed, as profit properly attributable to such a permanent establishment. In the calculation of such profit by banking enterprise, interest paid can be taken as a deduction by virtue of article 7(3), read with article 11(7). Therefore, it was held that as far as the remittance of interest is concerned, neither could the permanent establishment nor could the branch and the head office be treated as one entity for the purpose of deduction of tax under section 195 of the Act.

Further, the High Court also stated that the word 'chargeable' as used in Section 195 is not to be taken as qualifying the phrase 'any other sum' only but it qualifies the word 'interest' also. Therefore, in case where the remittance of interest results in an income which is chargeable under the Act, in those circumstances, tax may be deducted at source. But where the interest is not so chargeable under the Act, no tax is required to be deducted. In the instant case, by virtue of the Convention, the head office of the assessee was not liable to pay any tax under the Act. Therefore, there was no obligation on part of the assessee's Indian branch to deduct tax while remitting interest income to its head office or any other foreign branch. As a result, if no tax was deductible under section 195(1) and section 40(a)(i) would not come in the way of the assessee claiming such deduction from its income. Therefore, the assessee would be entitled to deduct such interest paid, as permitted by the Convention or Agreement, in the computation of its income.

However, now the Finance Act, 2015 has brought about amendment to section 9 as under;

In clause (v), after sub-clause (c), the following Explanation shall be inserted, namely:—

'Explanation.—For the purposes of this clause,—

(a) it is hereby declared that in the case of a non-resident, being a person engaged in the business of banking, any interest payable by the permanent establishment in India of such non-resident to the head office or any permanent establishment or any other part of such non-resident outside India shall be deemed to accrue or arise in India and shall be chargeable to tax in addition to any income attributable to the permanent establishment in India and the permanent establishment in India shall be deemed to be a person separate and independent of the non-resident person of which it is a permanent establishment and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery shall apply accordingly.

Simultaneously, section 195 (6) has been amended by the Finance Act, 2015 w.e.f 01.06.2015 as "The person responsible for paying to a non-resident, not being a company, or to a foreign

company, any sum, whether or not chargeable under the provisions of this Act, shall furnish the information relating to payment of such sum, in such form and manner, as may be prescribed."

Therefore, where any branch in India makes interest payment to the HO, it will be liable to deduct TDS at the time of remittance.

Hence, the situation post such amendment is as under;

Particulars	Pre- amendment		Post-amendment
	Non-Treaty scenario	Favourable Treaty scenario	Treaty as well as non-treaty scenario
Income of PE in India	100	100	100
Less: Interest payment to HO (as per the DTAA, without withholding of tax)		20	20
Taxable income of the PE	100	80	80
Income of the HO in India	-	Nil	20

Reference is also made to a very recent ruling in the case of Standard Chartered Grindlays P Ltd (ITA No. 3578/Del/2013) 80 taxmann.com 99 wherein the Delhi Tribunal held that interest on monies borrowed by the Indian branch from its Head office outside India is not a tax deductible expense both under the domestic tax law as well as under India-UK DTAA.

11.7.3 Discounting Charges

In the case of *ABC International Inc. [2011] 241 CTR 289 (AAR)*, the taxpayer company was tax resident of the United States. It was engaged in the business of providing various financial services to its group companies and unrelated companies. The taxpayer company's group company (hereafter referred to as "Indian company") in India was engaged in the business of exporting agricultural commodities against bills of exchange/promissory notes. The Indian company proposed to discount the bills of exchange/promissory notes with the taxpayer company on "non-recourse basis". The taxpayer company did not have a permanent establishment (PE) in India.

The issue before the AAR was whether the discounting charges for the bills of exchange/promissory notes by the Indian company could be characterized as interest within the meaning of Article 11 of the double taxation avoidance agreement between India and the United States ('the treaty').

The AAR observed that the term "interest" was defined in the Act to mean interest payable in any manner in respect of any moneys borrowed or debt incurred. Similarly, the term "interest" was defined in Article 11(4) of the treaty to mean income from debt-claims of every kind. The AAR noted that the discounting of a bill of exchange/promissory note was distinguishable from pledge or deposit of a security. In the AAR's view, the discounting of a bill of exchange/promissory note amounted to purchase of a negotiable instrument and it did not

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involve a debtor-creditor relationship between the endorser and endorsee.

In view of the above, the AAR held that the discounting charges could not be characterized as 'interest income' under the Act as well as the treaty and thus was not taxable in India. Therefore, Article 11 of the treaty did not apply in the present case. The AAR also held that, in absence of the taxpayer company's PE in India, the discounting charges were not taxable in India under Article 7(1) of the treaty.

Further reference can be made to the case of *CIT vs. Cargill Global Trading (P.) Limited* [2011] 335 ITR 94 (HC Delhi). In this case, the assessee was engaged in export business. The assessee drew bills of exchange on its buyers situated outside India with regards to export made to them. The assessee discounted these bills from its associated enterprise viz. Cargil Financial Services Asia P. Ltd (CFSA), Singapore. The assessee claimed deduction for discount paid to CFSA under section 37 of the Act. The Assessing Officer ('AO') held that the discount was actually an interest within the meaning of Sec. 2(28A) of the Act and hence, it was taxable in India. Accordingly, AO disallowed the deduction for the discounting charges, invoking provisions of Section 40(a)(i). On appeal the CIT(A) deleted the addition made by the AO holding that the discount paid by the assessee to CFSA cannot be held as interest. On appeal by the revenue, Tribunal affirmed the order of the CIT(A) and observed that discounting charges were not in the nature of interest paid by the assessee, rather assessee had received net amount of bill of exchange accepted by the purchaser after deducting amount of discount. Since CFSA was having no permanent establishment in India, it was not liable to tax in respect of such amount earned by it and therefore, the assessee was not under an obligation to deduct tax at source under section 195 of the Act and allowed the claim of the assessee.

On further appeal by the revenue, the Delhi High Court confirmed the order of the Tribunal and held that it is clear from the provisions of section 2(28A) that before any amount paid is construed as interest, it has to be established that the same is payable in respect of any money borrowed or debt incurred. In the instant case, discounting charges paid were not in respect of any debt incurred or money borrowed, instead, the assessee had merely discounted the sale consideration receivable on sale of goods. The High Court also relied on the decision of Supreme Court in the case of *Vijay Ship Breaking Corporation* [2008] 314 ITR 309 (SC) and CBDT circular No. 65 dated September 2, 1971 and CBDT circular No. 674 dated March 22, 1993. The CBDT circulars had clarified that discount was not interest and TDS u/s 194A was not applicable.

It is worthwhile to note that the special leave petition filed by the income-tax department against the aforesaid order of the High Court has been dismissed by the Supreme Court. [CC Nos. 19572 & 21458 of 2011].

It may further be noted that though the Gujarat HC's order was reversed by the SC (314 ITR 309) in the *Vijay Ship Breaking Corporation* case (supra), the finding that usance charge is interest u/s 2(28A) has not been reversed, but the usance interest has been held to be exempt from tax only based on Explanation (2) inserted retrospectively in section 10(15)(iv)(c) by the Taxation Laws (Amendment) Act, 2003 in respect of ship breaking activity. Similar observations

were made by Tribunals in Uniflex Cables Ltd (2012)(136 ITD 374)(ITAT Mum), Bhavani Enterprise (2014)(52 taxmann.com 489)(ITAT Panaji) and Indian Furniture Products Ltd (2015)(67 SOT 433)(ITAT Panaji).

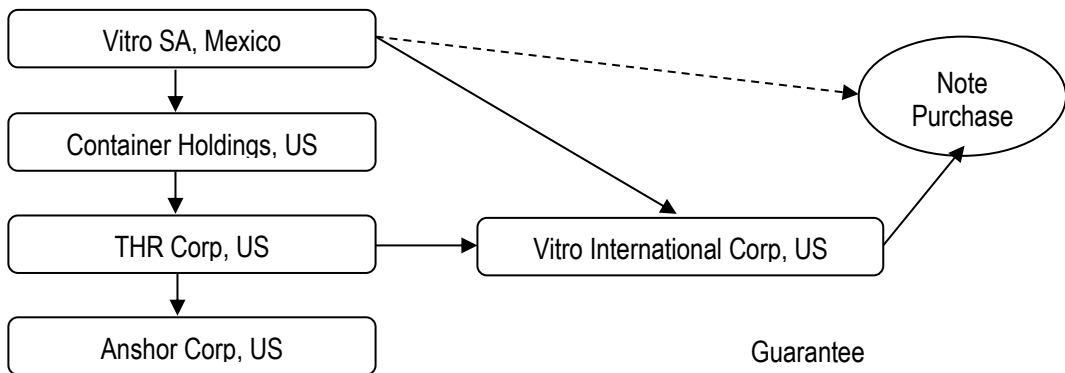
11.7.4 Guarantee Fees

The taxation authorities across the countries are putting considerable effort in dealing with the complex issues which may arise as a result of the various financial transactions that are taking place. One of such transaction is the “Credit guarantee fees”, particularly where the taxation authority perceives the fee to be “high” or when the total amount paid is significant.

Guarantee is an undertaking or promise that is collateral to the primary or principal obligation and that binds the guarantor to performance in the event of non-performance by the principal obligor. It is for a consideration which does not bear the characteristic of interest. The obligation in the case of guarantee is secondary in nature and as the guarantor does not extend funds it lacks the principal characteristic of loan. Guarantee fees are payments for a possible future action and thus be treated as compensation for services performed rather than interest.

The Code and regulations do not provide any explicit rule for the treatment of guarantee fees, and thus taxpayers, the government, and reviewing courts have been forced to determine taxability of guarantee fees by analogy to other similar provisions. A common practice in this regard has been to analogize the guarantee fee payment to an interest payment.

However, a different view was taken in the case of *Container Corporation vs. Commissioner* [134 T.C. No. 5 (February 17, 2010)], wherein a Mexican Corporation, Vitro SA, guaranteed the debt of its third generation U.S. Subsidiary, Vitro International Corporation. Vitro International, US, issued Notes to US lenders and these Notes were guaranteed by Vitro SA, Mexico (the facts of the case are diagrammatically depicted below). The U.S. subsidiary paid a guarantee fee to the Mexican corporation and did not withhold U.S. income-tax from the guarantee fee, taking the position that the guarantee fee was foreign source income.



The Internal Revenue Service (‘IRS’) argued that the guarantee fee was U.S. source income, but the Tax Court held in favour of the taxpayer. The Internal Revenue Code provides source rules for certain types of income. If an income category is not addressed in the code, its source

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should be determined by the statutory rule that applies to the most similar type of income. No source rule specifically applies to guarantee fees. Interest income is generally sourced to the residence of the borrower, and services income is generally sourced to the location where the services are performed. The Tax Court concluded that the guarantee fee is not interest because the Mexican parent did not make a loan to the U.S. subsidiary and that the guarantee fee is not compensation for services because the value of the guarantee stems from the promise made, not from an applied intellectual or manual skill. Because the guarantee fee is neither interest nor services, it had to be sourced using the rules for the type of income most analogous to a guarantee fee. The Tax Court concluded that a guarantee fee is most analogous to services income and therefore should be sourced to the location of the party that produced the guarantee i.e., Mexico. It came to this conclusion because the business activities generating the guarantee fee took place at the location of the guarantor. It was the Mexican parent's promise and its Mexican assets that produced the guarantee fees.

It is pertinent to note that the law in US has since been amended to include in the tax ambit the amounts paid by the US corporations or non-corporate residents for the guarantee of such US corporations or non-corporate resident's indebtedness. These amounts paid as guarantee fee are now considered as US source income being liable to withholding tax unless specifically excluded by double taxation convention.

Coming to the Indian context, the term "interest" has been defined under its domestic law to include 'any service fee or other charge in respect of money borrowed or debt incurred'. Thus, going by the definition it can be said that guarantee fees partakes the character of interest. At the same time, in view of the reasoning as provided in the case of Containers Corporation (*supra*) it can be argued that the same is not a service fee and hence not in the nature of interest. Further, in the case of cross border scenario, the definition of interest needs to be analysed in the context of definition as per the double taxation convention and if service fees are not so included, then depending upon the facts of the case guarantee fees may qualify as business income as covered under Article 7 or other income as covered under Article 21.

A reference can be drawn to the case of *ACIT vs GMAC Financial Services Pvt Ltd [2012] 25 taxmann.com 4143(Chennai ITAT)* wherein the assessee Company paid guarantee commission to holding Company M/s GMAC, USA. The Honorable Tribunal upheld the view of the CIT(A) that "the payment towards guarantee fee cannot be regarded as income from debt claim as per article 11 of the Double Taxation Avoidance Agreement entered into between India and the U.S.A. A similar decision has been rendered in the case of *Vetas Wind Technology(2016)(69 taxmann.com 382)* by the Chennai ITAT wherein in respect of wind turbine generators sold by the assessee –company in domestic market ,its holding company located in Denmark gave performance guarantee to customers and in consideration, thereof assessee paid corporate guarantee fee to the holding company, the payment was not regarded as interest in terms of Indo-Denmark DTAA; it was regarded as business profit of the parent company.

Likewise, in the case of *Neo Sports Broadcast (P) Ltd (2016) 159 ITD 136*, the Mumbai Tribunal held that bank guarantee commission cannot be treated as interest within the meaning of section

2(28A) of the Act.

In a recent ruling in Johnson Matthey Public Ltd. Company (2018) 191 TTJ 1 (Del ITAT), the assessee, a UK based company, provided guarantee to various bankers for extending loan facilities to its Indian subsidiaries. The Delhi Tribunal held that the guarantee fee charged by it from those subsidiaries would not fall within the expression of 'interest' under section 2(28A) of the ITA as well as under Article 12(5) of the India –UK DTAA, as the assessee was a stranger to the privity of loan contract between the Indian entity and the banker. It further ruled that in view of Article 23(3) of the India-UK DTAA, in the absence of any specific provision dealing with corporate/bank guarantee recharge, the same had to be taxed in India as other income as per the Act.

11.7.5 Unpaid Purchase Price

In Saurashtra Cement & Chemical Industries Ltd (1975) 101 ITR 502 (Guj HC), the assessee company was engaged in the business of manufacturing cement and was incorporated in India. The Company entered into an agreement with M/s. Ansaldo S.P.A of Genoa, Italy 'foreign company' to import certain plants and machinery. The price was to be paid in instalments as per the agreement. The issue before the authorities was whether the unpaid price can be held as loan advanced by the foreign company.

It was held that where the unpaid price was to be paid by bills of exchange drawn in a foreign country and accepted by the assessee company in India and where the foreign company is carrying on its business outside India, held that the debt which the assessee company owed to the foreign company was not an asset held by foreign company in India. Thus, the unpaid purchase price cannot be said to be loan and the interest which was payable in respect of this debt cannot be said to be income deemed to accrue or arise in India and hence not taxable.

Capital gains:

The Delhi High Court in the case of Zaheer Marutius v. DIT(IT) (2014) 270 CTR 244/47 has held that income arising on sale of compulsorily convertible debentures is to be treated as Capital gains and not interest, as the relationship between the Buyer and Seller cannot be equated with a Borrower-Lender

11.7.6 Interest on Income Tax Refund

In the case of *ACIT vs. Clough Engineering Ltd.* [2011] 9 ITR (Trib.) 618 (Delhi) (SB), the Clough Engineering Ltd ('the taxpayer') was tax resident of Australia and engaged in the business of carrying out oil and gas construction projects. The taxpayer company had a permanent establishment (PE) in India in respect of the said projects. During the relevant tax year, it had received interest on income-tax refunds (in India). The taxpayer company claimed that the said interest income was taxable in India at 15 percent on gross basis (i.e. without deduction for related expenses, if any) under Article 11(2) of the treaty. On the other hand, the tax authorities claimed that the said interest income was effectively connected with the taxpayer company's Indian PE and Article 11(4) of the treaty needs to be applied in the present case. Thus, the interest income will be taxable under Article 7(1) of the treaty (i.e. at the normal tax rate that

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was higher than the 15 percent withholding tax rate under Art. 11(2) of the treaty).

The issue before the Tribunal was whether the interest income was taxable at 15 percent on gross basis under Article 11(2) of the treaty.

The Tribunal observed that the taxpayer company was neither a banking company, nor engaged in money-lending business. Therefore, as such, the above-mentioned interest income did not amount to 'business income'.

The taxpayer company pointed out that tax was withheld by operation of the law (as a result of which the taxpayer company had received an income tax refund along with interest). Therefore, the taxpayer company contended, the tax authorities 'indebtedness' (giving rise to the interest on tax refund) could not be regarded as effectively connected with the taxpayer company's PE in India.

The Tribunal observed that interest on income tax refund could not be regarded as effectively connected with the taxpayer company's PE in India, as the liability to pay tax was on account of the taxpayer company, i.e. the head office in Australia, and not the Indian PE and the tax was withheld by the taxpayer company's customers as a result of the operation of the Act, such withholding tax did not establish an effective connection with the taxpayer company's Indian PE.

In view of the above, the Tribunal held that Article 11(4) of the treaty did not apply in the present case. As a result, Article 7(1) of the treaty did not apply to the interest on income tax refund. Consequently, it was held that the above-mentioned interest income was taxable in India at the rate of 15 percent under Article 11(2) of the treaty.

The Mumbai tribunal in the case of *Bechtel International Inc. vs. ADIT [2012] 135 ITD 377 (Mumbai ITAT)*, relying on the decision of Clough Engineering (*supra*) has held that the interest on income-tax refund would be taxable as interest income at 15 percent on gross basis and not as business income. In the case of Clough Engineering (*supra*) the treaty involved was India-Australia which uses the phrase 'effectively connected', however in the present case the tax treaty involved was India-USA which uses the term 'attributable'. In the light of the commentary of Klaus Vogel, the Tribunal held that though the US Model convention deviates from OECD and UN Model Conventions and uses the word 'attributable to' in place of 'effectively connected'. The phrase 'attributable to' as appearing in US Model Conventions has to be construed as equivalent to 'effectively connected'.

Similar view was taken in the case of *DHL Operations BV v DIT ITA No. 431 of 2012 (Bombay HC)*, *Marubeni Corpn. [IT Appeal No. 939 (Mum.) of 2012, dated 8-8-2013]*

A contrary view has been expressed in [2015] B. J. Services Co Middle East Ltd (380 ITR 138)(Utt).wherein the Uttarakhand HC held that the interest on income-tax refund was effectively connected with the assessee's PE in India and was hence taxable as business income by virtue of Article 12(6) of the India – UK DTAA.

A similar view has been expressed by the Delhi Tribunal in the same assessee's case in (2017) 77 taxmann.com 218 (Del ITAT).

11.7.7 Interest on Compensation

Reference can be made to the case of *Goldcrest Exports v. ITO* [2010] 134 TTJ 355 (ITAT Mum.) wherein Goldcrest Exports ('the taxpayer') was the tax resident of India. It was engaged in the business of exporting, importing and trading in various commodities. During the relevant tax year, the taxpayer company had claimed deduction for compensation payable to a company (hereafter referred to as "the UK Co") that was tax resident of the United Kingdom. The said compensation was payable as a result of an arbitration award in respect of a contract that was entered into by the taxpayer company with the UK Co., through an independent broker. As per the said arbitration award, the taxpayer company was also liable to pay interest to the UK Co (at 5 percent per annum, for the period beginning on a specific date and ending on the date of payment of compensation by the taxpayer company to the UK Co).

The issue raised was whether the compensation receivable by the UK Co was exempt from tax in India under Article 7(1) of the treaty and if the interest receivable by the UK Co amounted to 'business profit' taxable in accordance with Article 7(1) of the treaty. Further, whether the taxpayer company was obliged to withhold tax under Section 195 of the Act at the time of making provision for compensation. The taxpayer company was in appeal before the Tribunal against the order of the CIT(A).

The Tribunal held that the compensation was in the nature of 'business profit' covered under Article 7 of the treaty. The tribunal relied on the decision of the Mumbai High Court in the case of *Islamic Investment Co. vs. UOI* 265 ITR 254 (Bom), and held that the amount of interest payable by the taxpayer company to the UK Co. lost its original character and assumed the character of a judgment debt. As a result, in sum and substance, the interest partakes the character of the compensation which was not taxable in India as per Article 7(1) of the treaty. The Tribunal also stated that the company was not obliged to withhold tax under Section 195(1) of the Act. Therefore, the taxpayer company was entitled to deduction for the above mentioned provision for compensation; it was not subject to disallowance under Sec. 40(a)(i) of the Act.

In the case of *Islamic Investment Co. v. UOI* 265 ITR 254 (Bom), the Bombay High Court held that if the amount is paid as interest to a non-resident in the usual course of business, then at the time of credit of such amount to the account of the payee, or at the time of payment thereof in cash, or by issue of a cheque or draft, the payer would be bound to deduct income-tax at the rate in force; However, as observed by the Supreme Court in *All India Reporter Ltd. v. Ramchandra D. Datar* AIR 1961 SC 943 when such amount becomes part of a judgment debt, it loses its original character and assumes the character of a judgment debt. Once such an amount assumes the character of a judgment debt, the decree passed by the civil court must be executed subject only to the deductions and adjustments permissible under the Code of Civil Procedure, 1908. There is no provision under the Income-tax Act or under section 195 in particular or under the Code of Civil Procedure where the amount of the interest payable under a decree was deductible from the decretal amount on the ground that it was an interest component on which tax was liable to be deducted at source.

11.7.8 Upfront Appraisal Fees

In the case of *DIT vs. M/s. Commonwealth Development* [ITA No. 1058 of 2011, HC Bombay], the taxpayer was a company incorporated under the laws of United Kingdom and engaged in the business of advancing loans. However, before advancing loans, it examines the creditworthiness of the borrower and the financial efficacy of advancing the credit facilities. The Company charges a fee being 'upfront appraisal fee' for carrying out such appraisal. The reports of such appraisal are not furnished to the applicant or borrower but fee is charged irrespective of whether the loan/ credit facility is advanced to the applicant or not.

The Joint Commissioner of Income-tax considered such fees to fall under the head 'Income from other sources' and raised a demand. The Tribunal deleted the addition made by the assessing officer. The issue before the High Court was whether such upfront appraisal fees will qualify as Interest as defined under the Act or under the India-UK Tax Treaty (Article 12) or as fee for technical services as defined under Article 13 of the India-UK tax treaty.

The High Court stated that "*The fee is not payable in respect of any money borrowed or debt incurred. It is the debt itself.*" It was also stated that nor can the payment be said to be service fee or other charges in relation to moneys borrowed, as such payment is required to be made irrespective of whether or not the loan transaction was entered into or not. The said fees were paid towards the appraisal work which by its very nature was entirely different from the loan transactions. Thus, it was held that the said fee will not qualify as interest under the Act or under Article 12(5) of the India-UK tax treaty.

Further, it was held that the entire appraisal process was to enable the Company to take a decision as to whether the credit facilities ought to be advanced to the applicants or not and therefore in this process no technical or consultancy services was imparted by the Company to the applicants or borrowers. In view of the same, it was held that the payment made will not fall under Article 13 'Fees for Technical Services' of India-UK tax treaty. It was stated that the upfront appraisal fees was business income and could not be charged under Article 7 of the tax treaty as the Company did not have any permanent establishment in India.

11.7.9 Interest on Bid Money

In the case of *Cauvery Spinning and Weaving Mills Limited vs. DCIT* [2011] 238 CTR 55 (HC Chennai), the petitioner was a company under liquidation and the mill belonging to the petitioner was ordered to be sold by the Company Court in public auction. The bidder in whose favour the sale was confirmed requested for the payment of certain consideration in instalments. The aforesaid request was considered by the Company Court on a condition that the bidder will pay fixed percentage of interest on such instalments.

The issue before the Court was whether the amount in question received by the Official Liquidator forms part of the sale consideration so as to fall within the head of "Capital gain" or the same is interest, pure and simple, so as to fall within the head of "Income from other sources".

The High Court observed that on a close reading of the definition of interest as provided under

section 2(28A) of the Act it is clear that to call an amount received as interest, at least one of the conditions should be satisfied, namely, the same should have been received as a due on account of any money either borrowed or debt incurred. Here, in this case, the amount which was agreed to be paid, though by way of interest by the bidder as per the order of the Company Court, is not on account of any money either borrowed or debt incurred. Therefore, the amount in question cannot be treated as interest at all as defined in the above provision.

11.7.10 Usance Charges

In the case of *CIT vs. Vijay Ship Breaking Corporation [2008] 314 ITR 309 (SC)*, the taxpayer was engaged in the business of ship breaking and has purchased two ships from the foreign suppliers in the United Kingdom and Singapore under a Memorandum of Agreement (MOA) for a total stated purchase price of the ships wherein a 180 days usance period from the date of the physical delivery of the ships was agreed and the rate of interest was set out. The interest was stipulated to be paid from the date of the notice of the release for the usance period computed on the purchase price of the ships and the amount was to be paid by means of an irrevocable 180-day usance letter of credit.

The tax authorities took the view that the assessee was in default on account of non-deduction of withholding taxes on payment of interest to non-resident. The tax payer argued purchase price of the ships and the interest paid in respect of the usance credit constituted the total purchase price of the ships and, therefore, no interest was paid that required the imposition of withholding tax.

The issue before the High Court was whether or not the usance interest paid by the taxpayer to the foreign suppliers of the ships fell within the scope of the definitions of “interest” in the Act and Article 11 of the India-UK and India-Singapore treaty.

The High Court held that the payment of usance interest was not part of the purchase price of the ships, but was rather “interest” as claimed by the tax authorities. The Court observed that the interest is defined broadly to include interest on an unpaid purchase price payable in any manner and covering amounts payable under an irrevocable letter of credit. It was also stated that the purchase price of the ships became outstanding on the date of delivery and, as it had not paid cash on delivery, interest was contractually charged at the specified rate for the usance period.

However, on appeal to the Supreme Court, it was held that “...we are not required to examine this question in the light of the impugned judgment because after the impugned judgment which was delivered on 20-3-2003, the Income-tax Act was amended on 18-9-2003 with effect from 1-4-1983. By reason of said amendment, Explanation 2 was added to section 10(15)(iv)(c)...”.

As per the amendment it is clear that usance interest is exempt from payment of Income-tax if paid in respect of ship breaking activity and thus it was held by the Supreme Court that the assessee was not bound to deduct tax at source once Explanation 2 to section 10(15)(iv)(c) stood inserted as withholding tax liability arises only if the tax is assessable in India.

However, in the case of *ACIT vs Indian Furniture Products Ltd [2015] 53 taxmann.com 440*

(*Panaji ITAT*), it was stated that "The Gujarat High Court in *CIT v. Vijay Ship Breaking Corpn.* [2003] 261 ITR 113/129 Taxman 120 has taken the view that the usance charges are interest within the provisions of section 2(28A) and has accrued in India, therefore section 195 was clearly applicable and assessee has committed default by not deducting TDS. When the matter went before the Supreme Court, Explanation (2) was inserted under section 10(15)(iv)(c) by the Taxation Laws (Amendment) Act, 2003 with retrospective effect from 1-4-1962.....From the reading of this explanation it is apparent that this explanation is applicable only in a case where an undertaking is engaged in business of ship breaking and usance charges are payable outside India by that undertaking in respect of purchase of a ship from outside India. The nature of the business of the assessee is not that of ship breaking. This explanation is applicable only to ship breaking activity, not to other activities. Therefore, Explanation (2) to section 10(15)(iv)(c) on which the assessee has heavily relied, will not assist the assessee.... From reading the decisions of the Supreme Court and the Gujarat High Court it is apparent that the Supreme Court has not reversed the decision in the case of *Vijay Ship Breaking Corpn.* (supra) on the finding that the usance charges are not interest under section 2(28A) except where an undertaking is engaged in the business of ship breaking in view of Explanation (2) to section 10(15)(iv)(c) inserted by the Taxation Laws (Amendment) Act, 2003 with retrospective effect. The decision of the Gujarat High Court has impliedly been approved by the Supreme Court in respect of assesseees who are engaged in the business of ship breaking."

Therefore, in the present case where the assessee being engaged in manufacture of wooden doors, frames, furniture etc. paid usance charges on import purchase, the same was interest and hence was income of the non-resident and therefore, assessee was liable to deduct TDS u/s 195, which was not done, hence, disallowance u/s 40(a)(i) was attracted.

A similar view was taken in the case of *ACIT v. Bhavani Enterprises* [2014] 52 taxamn.com 489 (*Panaji – Trib.*) and *Uniflex Cables Ltd. V. DCIT* [2012] 136 ITD 374 (*Mumbai*)

11.7.11 Interest on Convertible Bonds

In the case of *LMN India Limited* [2008] 307 ITR 40 (AAR), the applicant was an Indian non-banking financial company into the business of making investments. The applicant proposed to borrow money from LMCC USA (the investor) by issuing fully convertible bonds by way of a Bond Subscription Agreement (BSA) in order to fund its business. As per the BSA, the bonds (with the face value of INR 10 each) were convertible into equity shares at the end of 5 years from the date of the issue unless extended for a further period of 5 years. The interest on the bonds was payable by the applicant in INR in cash on a half-yearly basis irrespective of whether or not the applicant was profitable. The investor did not have a permanent establishment or fixed base in India.

The following issues were raised before the AAR:

- if interest payable to the investor up to the date of conversion of bonds into equity shares should be treated as "interest" on money borrowed or debt under the Act and under Article 11(2) of the India-United States Double Taxation Avoidance Agreement ('the treaty') and

accordingly taxable as such;

- if such payment could be treated as “dividend” income of the investor; and
- whether applicant needs to deduct tax at source under the Act in respect of the above transactions.

The AAR held that the payment made to the investor was an interest payment on money advanced to the applicant or on a debt incurred by the applicant and satisfied the definition of “interest” under Section 2(28A) of the Act as well as Article 11(4) of the treaty. Accordingly, the interest income was taxable in India. It was also held that such interest payments cannot be viewed as dividend income of the investor. “Dividend” pre-supposes that the payee holds shares in a company. The bond-holder would become shareholder only upon conversion of the bonds into equity shares. As per company law, dividends can only be paid out of profits, whereas in the present case, interest was payable to the bond-holder irrespective of whether or not the applicant was profitable. Accordingly, the payment made to the investor on convertible bonds was held to be taxable in India as interest income.

11.7.12 Sale of Compulsory Convertible Debentures

In the case of *Z, In re [2012] 249 CTR 225 (AAR)*, “Z” a company incorporated under the laws of Mauritius and tax resident of Mauritius, had subscribed to zero percent Compulsorily Convertible Debentures (CCD) of “S”, an Indian company. “Z” transferred CCDs to “V” (Parent Company of S) and contended that capital gains arising to it from transfer of securities held in S are exempt from tax in India under Article 13(4) of the India-Mauritius DTAA.

The AAR observed that the CCDs were in the nature of debt, which did not carry a fixed interest but instead gave an option for conversion into shares at a future price. On an examination of the agreements of investment in India and its subsequent sale, the AAR observed that the Company S (issuer of CCDs) was controlled and managed by Company V. The AAR lifted the corporate veil of S to observe that the payments made by V to the applicant were not on account of the purchase of CCDs but were, in effect, payment of interest on the CCDs, taxable as such in the hands of the Applicant, under the Act as well as the India - Mauritius DTAA.

The AAR observed that Article 11 deals with the treatment of income from debt-claims of every kind, whereas, Article 13 deals with gains from the alienation of any property. Article 11 being a specific provision will be applicable in the present case where V has paid a fixed predetermined return to the Z. The AAR thus ruled that the appreciation in the value of CCDs is clearly payment of “interest” and taxable under the provision of Article 11 of the DTAA.

However, this case has been reversed in the case of *Zaheer Mauritius vs DIT [2014] 47 taxmann.com 247*, wherein the facts were that the assessee is a Company incorporated in Mauritius and a tax resident of Mauritius engaged in the business of investment into Indian Companies engaged in construction & development business in India. The assessee entered into a Securities Subscription Agreement (SSA) and a Shareholders Agreement (SHA) with Vatika, an Indian Company and its 100% subsidiary company incorporated in India by the name SH Tech Park Developers Pvt Ltd (JV Company) and agreed to acquire 35% ownership interest

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in the JV Company by way of its equity shares and CCDs. The said agreement also provided for a call option given to Vatika by the Company to acquire all the aforementioned securities during the call period and likewise, a put option given by Vatika to the assessee to sell to Vatika all the aforementioned securities during the determined period. Later on, Vatika exercised its call option and purchased part number of equity shares and entire CCDs from the assessee. The assessee filed an application u/s 197 requesting a NIL withholding tax certificate on transfer of such securities.

The Assessing Officer held that the entire gain on this transfer would not be capital gain but interest and taxed @ 20%. The issue raised was whether the capital gain on sale of CCD's could be treated as interest.

It was held by the Delhi High Court that gains arising to Mauritius company from sale of CCD's in JV Company to Indian Partner under exit option was not "interest" u/s 2(28A) but "capital gains" even if the exit option assures a minimum assured return. Whether a CCD is a loan simplicitor or whether it is in the nature of equity, is not material in determining whether the gain thereon is a capital gain or not. This depends entirely on whether the debentures are capital assets in the hands of its holder. Although, the SHA enables the assessee to exit the investment by receiving a reasonable return on it, and in that sense it is assured of a minimum return, the same cannot be read to mean that the CCDs were fixed return instruments, since the assessee also had the option to continue with its investment as a equity shareholder of the JV Company. Further, the pre-mature exit options as recorded in the SHA and the minimum return assumed by Vatika on its investment are clearly commercial agreements between the parties. Thus, there is no reason to ignore the legal nature of the instrument of a CCD or to lift the corporate veil to treat the JV Company and Vatika as a single entity. Thus, the sale of CCD's was not held as interest.

11.7.13 Interest on Capital Gains

In the case of *Genesis Indian Investment Co. Ltd. V. CIT*[2013] 36 com 300 (Mumbai – Trib.) the interest was received in pursuance to the directions of the SEBI and due to delay in completion of the process of buy back of shares as prescribed under the SEBI regulations. The real acquisition of shares took place only in the month of November 2001 and prior to the said date it cannot be said that the interest was paid due to delay in the payment of consideration. Therefore, it was held that the additional amount received by the assessee being 15% interest from 8.8.2000 to 22.11.2001 is part of sale consideration and accordingly will be treated as part of capital gain and not the income from interest.

11.7.14 Prepayment Discount

In the case of *DCIT vs Kothari Food & Fragrances* [2014] 50 taxmann.com 213 (Lucknow Trib), the assessee-seller gave discount to its foreign buyers on sales. Such discount was not a part of the agreement entered into between the assessee and the foreign buyers and hence, the Assessing Officer "opined that the payment to non-resident was not under any contractual obligation as no stipulation regarding payment of discount to non-resident was made in the contract-note entered into by the assessee with the non-resident company and payment of

discount was in the nature of interest and, therefore, TDS was deductible under section 195(1).". It was held that "the benefit allowed by the assessee to its buyers under the name of discount was in fact in the nature of interest because the same was in consideration of receiving advance payment. On receiving advance payment, one may compensate the maker of advance payment by way of allowing interest or the same benefit can be given the name of discount but merely because a different nomenclature has been given, it does not change its character. Under these facts, TDS was deductible under section 195 and therefore, the disallowance made by the Assessing Officer was justified."

11.7.15 Timing of accrual of interest on Government Securities and taxability of consideration towards the sale of securities as interest or capital gains under the India-Cyprus Tax Treaty.

In the case of *DIT vs. Credit Suisse First Boston (Cyprus) Limited [2012] 23 taxmann.com 424 (HC Bombay)*, the taxpayer was a company incorporated in and a tax resident of Cyprus and carried on business of banking and was registered in India with SEBI as an approved sub-account of Credit Suisse First Boston, a FII. The taxpayer had invested in Government Securities (as permitted by SEBI) wherein interest was payable every six months. The tax payer had offered for taxation interest income from debt securities received during the year and claimed exemption in respect of income on sale of debt securities under Article 14(4) of the India-Cyprus Tax Treaty.

The Assessing Officer taxed the interest accrued but not due at the end of the financial year i.e. on 31 March being the last day of the financial year. Further, he classified the gains arising on sale of Government debt securities to be interest covered within the meaning of interest as provided under Article 11(4) of the tax treaty and held it to be liable to tax in India as interest. On appeal, the CIT(A) deleted both the additions made by the assessing officer and ITAT upheld the order of the CIT(A).

The High Court held that when an instrument or an agreement stipulates interest to be payable at a specified date, interest does not accrue to the holder thereof on any date prior thereto. Interest would accrue or arise only on the date specified in the instrument. That a creditor has a vested right to receive interest on a stated date in future does not constitute an accrual of the interest to him on any prior date. It was also stated that whatever be the connotation of the term accruing in general parlance, for the purpose of the Income-tax Act, interest does not accrue during such periods to the creditor/ assessee. For want of a better term, it may be said that during such periods interest keeps mounting or if we may use the expression interest keeps ticking. The contention that interest accrues for broken periods between two consecutive dates stipulated in the agreement/ instrument for payment of interest is without any basis in law.

With regard to the second issue whether the sale of securities were covered under Article 14 dealing with capital gains under the tax treaty, the High Court stated that as per the definition of interest under Article 11(4) of the tax treaty the existence of a debtor-creditor relationship is necessary. The sale proceeds upon transfer of the security arise not from but on account of and represent the debt-claim/ security itself. The subsequent words of Article 11(4) of the tax treaty 'in particular, income from Government Securities and income from bonds or debentures'

constitute merely an inclusive provision which by way of illustration refer to Government Securities. It was also stated that the sale price in excess of the value of the bond cannot be said to be attached to the instrument or transaction. It arises independently and *de hors* the terms of the instrument.

Reference was also made to Para 20 of the Model Tax Convention which inter alia provides that 'any profit or loss which a holder of such a security realizes by the sale thereof to another person does not enter the concept of interest. Such profit or loss, may, depending on the case, constitute either a business profit or a loss, a capital gain or a loss, or income falling under Article 21 of the tax treaty'.

In view of the above, the High Court held that the consideration received by the taxpayer in respect of the sale of the said securities is a capital gain and falls under Article 14(4) of the tax treaty.

11.7.16 Taxability of interest on loan extended/ endorsed by specified Corporations/ institutions under India-France/ India-Sweden tax treaty?

The OECD Commentary (paragraph 7.6 of Article 11) states that in order to promote international trade, many States have established export financing programmes or agencies which may either provide export loans directly or insure or guarantee export loans granted by commercial lenders. Since that type of financing is supported by public funds, a number of States provide bilaterally that interest arising from loans covered by these programmes shall be exempt from source taxation. States wishing to do so may agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source: "if the interest is paid in respect of a loan, debt-claim or credit that is owed to, or made, provided, guaranteed or insured by, that State or a political subdivision, local authority or export financing agency thereof;"

In the case of *Poonawalla Aviation Private Limited [2011] 16 taxmann.com 120 (AAR)*, the applicant was an Indian Company who entered into an agreement for the purchase of an aircraft from French Company. The latter provided an export facility to the purchaser. This facility was insured by the *Compagnie Francaised' Assurance pour le Commerce Exterieur ('COFACE')*, a French export credit agency. The applicant executed promissory notes in favour of the seller. These promissory notes were irrevocably and unconditionally assigned by the seller to another French entity called BNP Paribas. Consequently, the applicant was required to deposit instalments to the BNP Paribas branch in New York.

The issues before the Authority of Advance Ruling (AAR) were as follows:

- As the payments were made in the New York branch of the BNP Paribas, will the India-USA tax treaty apply?
- Whether the interest payable to the seller is exempt under Article 12(3)(b) of the India-France tax treaty?
- Whether the interest payable to the seller is exempt in view of the Most Favored Nation

(MFN) clause under the India-France tax treaty?

- Whether there is an obligation on the applicant to deduct tax at source on the interest payable to the seller under Section 195(2) of the Act?

The AAR held that since there was no material proof on the transfer of beneficial ownership from BNP Paribas, France to its USA branch, the tax treaty between India and France would apply. Further, it was held that as the COFACE only provided insurance cover to the seller and its obligation to pay arises just in case of contingencies, it does not fall under the expression 'extension or endorsement of a loan' and is not exempt under Article 12(3)(b) of the India-France tax treaty.

Exemption under some DTAA

Some DTAA provide an exemption from tax on interest in case if paid or received by certain taxpayers who are generally exempt from tax on interest in various DTAA of India include”

- A) Interest paid to Government
- B) Interest guaranteed by Government
- C) Interest paid to Banks or other Financial Institutions
- D) Interest on loans to finance special equipments or public works

An example of the above exemption is in the case of Article 11(4) of the India-Mauritius DTAA which provides,

“Interest arising in a Contracting State shall be exempt from tax in the Contracting State to the extent approved by the Government of the State if it is derived and beneficially owned by any person [other than a person referred to in paragraph (3)] who is a resident of the other Contracting State provided that the transaction giving rise to the debt-claims has been approved in this regard by the Government of the first-mentioned Contracting State”.

The issue arising from the above issues is whether approval from the RBI under the ECB Regulations of the Foreign Exchange Management Act, 1999, can be considered as approved by the Government of India and therefore, not subject to withholding tax.

In this regard, the AAR in the case of Yu Bo Investment company private limited, In re (2004) 267 ITR 734 held that RBI approval is not provided for tax purposes and therefore, approval of the RBI would not be sufficient to claim the benefit of the Tax treaty.

The Authority further held that the appropriate authority for providing the approval in order to claim the exemption would be the Ministry of Finance of the Government of India.

Books/Articles/Websites referred to:

1. *Commentary of OECD & UN Model Convention*
2. *International Taxation Compendium- by The Chamber of Tax Consultants*
3. *www.taxmann.com*

12. Article 12 – Royalty and Fees for Technical Services

12.1 Introduction

Royalty, as commonly understood, is the fee paid for use of or right to use certain types of Intellectual properties belonging to another. Technical services, as commonly understood, is a fee paid for availing some services of technical nature.

The Provisions in respect of Royalties and Fees for Technical Services ('FTS') are generally contained in Article 12 of the treaties. In most of the tax treaties, the taxability of royalties and FTS is discussed in the same article. However, with FTS assuming growing importance with services becoming a prime commodity, in some of the new DTAA's being negotiated, FTS is covered in a separate Article after royalty. In some tax treaties, the concept of FTS is not present at all and in some treaties, FTS is referred to as FIS (Fees for included Services).

This chapter discusses some basic provisions with respect to Royalty / FTS under the treaties as also briefly touching upon the relevant aspects under the Act. The nub of topic lies much in determining whether a given payment constitutes Royalty / FTS having regard to the definitions and controversies surrounding the classification of such payment.

12.2 Article 12 of UN Model Convention (2011)¹⁵⁶

- Article 12(1) – Royalties arising in a contracting state and paid to a resident of the other contracting state may be taxed in the other state
- Article 12(2) – Such Royalties may also be taxed in the state in which they arise and according to the laws of that state. But if the beneficial owner of royalty is a resident of the other contracting state, the tax so charged shall not exceed the percentage established through bilateral negotiations of the gross amount of royalty (treaty rate).
- Article 12(3) – Meaning of the term Royalty (discussed in detail subsequently)
- Article 12(4) – Provisions of the Article not to apply in case the beneficial owner of royalties being a resident of a contracting state:
 - carries on business in the other contracting state in which royalties arise through a Permanent Establishment (PE) situated therein, or;
 - performs in that other state independent personal services from a fixed base situated thereinand, the right or property in respect of which royalty is paid is effectively connected with :
 - such PE or fixed base, or with
 - business activities referred to in Article 7(1)(c)
- Article 12(5) – Royalty shall be deemed to accrue or arise as under:

¹⁵⁶ Most DTAA's which India has entered into, are based on UN Model Convention(2011)

- Where the payer is a resident of a contracting state - in that state
- Where the payer (irrespective of his residence) has a PE in the other contracting state in connection with which liability to pay royalty was incurred, and such royalty is borne by such PE - in the state where PE or fixed base is situated.
- Article 12(6) – Where by reason of a special relationship between:
 - Payer and beneficial owner
 - Payer, beneficial over and some other person

the payment of royalty exceeds than what would have been paid in absence of such relationship, then the provisions of this Article shall apply only to the extent of amount which is not in excess. The excess amount shall be taxable as per the laws of the respective contracting states.

To put together, royalties may be taxed both, in the country of which the recipient is a resident and in the country in which it arises. Paragraph 1 outlines the basic rule that royalties may be taxed in the state of residence. Paragraph 2 entitles the state of source to tax income only to limited extent of withholding some percent of gross amount as tax. Paragraph 3 defines the term royalties. Paragraph 4 provides an exception with respect to that royalty which is in connection with a PE to which article 7 or 14 applies. Paragraph 5 provides for the circumstances where royalty shall be deemed to accrue or arise in a contracting state. Paragraph 6 provides for adjustment of an amount which is in excess of arm’s length principle.

12.3 Meaning / Definition of Royalty

12.3.1 Royalty under the Model Conventions

The definition of Royalty under the three Model Conventions (OECD model, UN model and the US model) is given in the table below:

OECD Model Convention	UN Model Convention	US Model Convention
The term ‘royalties’ as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience	The term ‘royalties’ as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process,	The term ‘royalties’ as used in this Article means any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including cinematograph films), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience

	or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience	
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The definition of “royalty” under the OECD Model Convention omits equipment royalty (i.e. the term “*use of, or right to use, industrial, commercial or scientific equipment*” is missing). As regards the US Model Convention, it broadly follows the OECD model.

12.3.2 Royalty under DTAA's

Each specific DTAA would have its own definition of the term “royalty”. Most DTAA's which India has entered into, are based on the UN model convention. Some peculiar features in relation to DTAA's which India has entered into, are as under:

- The DTAA's with countries such as Turkmenistan, Russia, Morocco and Trinidad and Tobago specifically include payments for “use of or right to use computer software” within the definition of the term “royalty”.
- In some DTAA's (such as those with Belgium, Israel, Netherlands and Sweden), the definition of the term “royalty” does not contain the provision for “use or right to use industrial, commercial or scientific equipment”. Further, India France DTAA has a separate clause for the use of or right to use any industrial, commercial or scientific equipment.
- India-USA and India Singapore DTAA's both incorporate the clause which includes gains derived from alienation. But unlike USA, the Singapore DTAA does not make it contingent upon productivity or use.
- In some DTAA's (such as those with Greece and United Arab Republic (Egypt)), the right to tax the “royalty” income has been conferred only to the source state. In most other DTAA's, both, the source state as well as the state of residence of the recipient have the right to tax such “royalty” income.
- The India UK treaty provides for a penal clause that the provisions of the Article shall not apply if the main purpose of the creation / assignment of rights in relation to which the royalties or fees for technical services are paid is to take advantage of this Article by means of that creation or assignment.
- Some of the DTAA's have a 'Most Favoured Nation' (MFN) clause pursuant to which a restrictive meaning is accorded to the term Royalty (Refer discussion in para 12.5.2, 10.2.9)

Accordingly, for examining the applicability and scope of “royalty” taxation in a particular situation, it would be critical to examine how the term has been defined in the relevant DTAA, what are the corresponding provisions under the Act and what are the specific rules for taxation.

12.3.3 Royalty under the Act

Explanation 2 to section 9(1)(vi) of the Act characterizes certain payments as “royalty”. The definition of the term “royalty” as provided in Explanation 2 to section 9(1)(vi) of the Act is as follows –

“Royalty means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head “capital gains”) for:

- (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;*
- (ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property;*
- (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property;*
- (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill;*
- (iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in section 44BB;*
- (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or*
- (vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).”*

In other words, royalty means –

- With respect to patent, invention, model, design, secret formula or process or trade mark or similar property, payments for –
 - Use;
 - transfer of all or any rights;
 - granting of a license;
 - imparting any information concerning their working or use.

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- With respect to technical, industrial, commercial or scientific knowledge, experience or skill, payments for:
 - imparting of any information.
- With respect to any industrial, commercial or scientific equipment (excluding where section 44BB of the Act is applicable), payments for-
 - Use;
 - right to use.
- With respect to any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting (not including consideration for the sale, distribution or exhibition of cinematographic films), payments for –
 - Transfer of all or any rights;
 - Granting of a license;
 - Payments for rendering services in connection with any of the above activities.

Broadly, the following conditions need to be satisfied for a payment to be characterized as “royalty” –

- The amount must not be in the nature of capital gains;
- The recipient must be the owner/license holder of the underlying asset in connection with which the royalty is received;
- The transaction must not be that of an outright sale.

12.3.4 When is royalty “deemed to accrue or arise” in India as per the Act?

As per section 9(1)(vi) of the Act, royalty income is deemed to accrue or arise in India in the following situations –

- Where the royalty is payable by the government to the non-resident recipient;
- Where the royalty is payable by a resident to the non-resident recipient, except -
 - where the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person (i.e., the payer) outside India; or
 - for the purpose of making or earning any income from any source outside India
- Where the royalty is payable by a non-resident to the non-resident recipient, only if -
 - the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a business or profession carried on by such person in India; or
 - for the purpose of making or earning any income from any source in India

The following payments are excluded from the above deeming provisions and therefore, not taxable in India:-

- Royalty payable under an agreement approved by the Central Government, if –
 - the agreement is made before 1st April, 1976;
 - for the transfer outside India of, or the imparting of information outside India;
 - in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property; and
 - the royalty payable is a lump sum consideration.
- Royalty payable in respect of computer software, if –
 - lump sum payment is made by a resident
 - for transfer of all or any rights (including granting of a license) relating to computer software supplied along with a computer or computer-based equipment
 - by a non-resident manufacturer
 - under any scheme approved under the Policy on Computer Software Export, Software Development and Training, 1986 of the Government of India.

Explanation 3 to section 9(1)(vi) defines the term “computer software” as *“any computer programme recorded on any disc / tape / perforated media / other information storage device and includes any such programme or any customized electronic data.*

The Finance Act 2012, made series of retrospective amendments to nullify various rulings involving interpretations pertaining to the definition of royalty.

Explanation 4 was inserted to clarify that irrespective of the medium through which the transfer of all or any right for the use or right to use computer software (including granting of license) would take place, the same would be treated as royalty.

Explanation 5 has been inserted to clarify that the term royalty includes and has always included consideration in respect of any right, property or information, whether or not-

- The possession or control of such right, property or information is with the payer;
- Such right, property or information is used directly by the payer;
- The location of such right, property or information is in India.

Explanation 6 has been inserted to provide that *“the expression “process” includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret;”*

Further, as per Explanation to section 9(2) of the Act, royalty income will be deemed to accrue or arise in India, whether or not –

- the non-resident recipient has a residence / place of business / business connection in India; or
- The non-resident recipient has rendered services in India.

12.3.5 Summarizing the meaning of Royalty

We have seen the definition of royalty under the Model Conventions and under the Act. To put together, the term royalty in general, relates to rights or property constituting different form of literary and artistic property, the elements of intellectual property and industrial and commercial property specified in the text and information concerning industrial, commercial or scientific experience or equipment. The definition applies to payments for use of or a right to use, the rights of the kind mentioned. The definition of royalty under the Act is broader than that under the treaty / model conventions.

Following are the broad features of the term royalty gathered from the definitions contained in OECD Model, UN Model and the Act. Royalty is payments of any kind received as a consideration.

- For use of, or the right to use,
- Copyright
- Patent, trademark etc.
- Industrial, commercial, or scientific equipment
- For imparting of information concerning technical, industrial, commercial or scientific knowledge, experience or skill
- For imparting any information concerning the working of or the use of a patent, invention, model etc.
- For the transfer of all or any right in respect of patent, invention, trademark, etc. and in respect of copyright

By virtue of section 90(2) of the Act, provisions of the Act shall apply to the extent they are more beneficial than the respective DTAA's. Thus, in view of the retrospective amendments made to section 9(1)(vi) by the Finance Act 2012 with regard to royalty, significantly widening the scope thereof, the narrower definition as contained in the tax treaties (if any) could come to the rescue of the taxpayer.

1.2.4 Some Illustrative Cases dealing with Royalty

Whether the relevant payment constitutes royalty and the taxability thereof is determined on the basis of the provisions of the Act read together with the governing treaty. Some principles emanating from some of the landmark rulings with respect to different payment types are discussed below:

12.4.1 Use of Satellite / Transponder Hire charges

The key issue in such cases is whether use of a satellite is a “process” and the use of a satellite transponder for up-linking and down-linking is “use of or right to use industrial, commercial or scientific equipment”. Further, even if there is a “process” involved, whether the “process” has to be a “secret process” so as to constitute a royalty? This situation is typically faced by telecasting companies in respect of payments made to satellite companies.

The Delhi High Court in the case of *Asia Satellite*¹⁵⁷ held that no income is deemed to accrue in India from the use of Satellite outside India to beam TV signals into India even if bulk of revenue arises due to viewers in India. In propounding this view, the Delhi High Court held that the control of the satellite was not parted with in the transaction and there is no use of 'process' by the TV channels in India. Further, it relied on the International tax Commentaries which state that use of a satellite is a service and not a rental and that there is a distinction between “letting an asset” and “use of the asset for providing services”

The effect of this verdict was seemingly overturned in view of the retrospective amendments to the definition of Royalty under the Act by Finance Act 2012. However, there have been several judgments post the amendments by Finance Act 2012, which lay down the principle that unilateral amendments under the Act cannot be read into the treaty and the taxpayer will continue to be governed by the provisions of the tax treaty to the extent they are more beneficial¹⁵⁸.

12.4.2 Leased line charges / Connectivity charges

The key issue here is whether payment for dedicated internet connectivity via leased line or a dedicated circuit constitutes payment for use of industrial, commercial or scientific equipment, or use of a process? Further, in this issue, there is a significant overlap between Royalty and FTS - the payment is reckoned as royalty from the angle of use of process / equipment and FTS from the perspective of rendition of technical services. The FTS angle in such payments has been addressed separately in Para 12.5.1.C

In several cases¹⁵⁹, it was held that payment towards bandwidth charges is not for use of or right to use industrial, commercial or scientific equipment. There are some recent decisions of Mumbai Tribunal¹⁶⁰ and Delhi Tribunal¹⁶¹ which have held in similar manner. However, in the decision of *Verizon Communications*¹⁶² the Madras High Court concluded that having regard to the retrospective amendments made in the definition of royalty by Finance Act, 2012, the payment for providing connectivity services are liable to be treated as Royalty under the Act.

¹⁵⁷ *Asia Satellite Telecommunications Co vs DIT* [2011] 332 ITR 340 (Del)

¹⁵⁸ *B4U International Holdings Ltd. vs DCIT* [2012] 21 taxmann.com 529 (Mum ITAT), *New Skies Satellite Bv.* [2016] 68 taxmann.com 8 (Del); *T-3 Energy Services India (P.) Ltd. vs JCIT* [2018] 91 taxmann.com 334 (Pune - Trib.)

¹⁵⁹ *Dell International Services* [2008] 172 Taxman 418 (AAR), *Infosys Technologies* (139 TTJ (Bang.) (UO) 18)

¹⁶⁰ *Interoute Communications Limited vs. DDIT* (ITA No. 2284/Mum/2014)

¹⁶¹ *M/s. Geo Connect Ltd. Vs. DCIT* (ITA Nos. 1927/Del/2008 & 127/Del/2011), dated 17 Jan 2017)

¹⁶² *Verizon Communications Singapore Pte Ltd .*[2014] 361 ITR 575 (Mad)

Thus, the judicial view in respect of leased line charges or bandwidth charges appears to be divided and may be prone to litigation.

12.4.3 Payment for software

This was one of the most controversial issues surrounding taxation of Royalty. The sale of software generally happens by way of entering into a license agreement. In such cases, the Revenue Authorities tend to proclaim that granting of a license to use the software is a right to use granted to the purchaser and hence, the payments are in the nature of royalties. The taxpayers contend that there is a difference between use of a copyright and that of a copyrighted article. As long as there is no commercial exploitation by the purchaser of the embedded copyright (e.g. creating multiple copies of the software for onward sale), it cannot be said to be a payment for “use of the copyright”, but is merely a purchase transaction which involves buying of a copyrighted article. The judicial view stands divided and the retrospective amendments to the definition of Royalty under the Act by Finance Act 2012 has intensified the controversy around the issue.

The Karnataka High Court in the case of Samsung Electronics¹⁶³ has held that a copyright is a bundle of rights and even the payment for purchase or use of off the shelf software amounts to royalty not only under the Act, but also under the USA treaty.

However, the Delhi High Court in the case of Infrasoftware¹⁶⁴ has expressed a disagreement with the decision of Karnataka High Court in Samsung’s case and observed that the license granted to the licensee permitting him to download the computer programme and storing it in the computer for his own use was only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purposes. This has also been observed in other cases¹⁶⁵.

In the case of Nokia Networks¹⁶⁶, the Delhi High Court held that there is a clear distinction between royalty paid on transfer of copyrights and consideration for transfer of copyrighted articles. Recently Mumbai Tribunal in the case of Reliance Communication¹⁶⁷ held that the consideration paid to the suppliers for acquiring copy of software was not the ‘use of copyright or transfer of right to use of copyright’ the payment was made for the ‘copyrighted article’ and that the payments made to the vendors of software cannot be taxed as royalty.

Recently, in case of **Engineering Analysis Centre of Excellence Private Limited (TS-106-SC-2021)**, Supreme Court referred to the terms of the agreements entered into with various parties for the use of software and noted that distributors were granted a non-exclusive and non-transferable license to resell the software. Furthermore, end users were granted a limited

¹⁶³ CIT vs Samsung Electronics Co. Ltd. [2012] 345 ITR 494 (Kar)

¹⁶⁴ DIT vs Infrasoftware Ltd. [2013] 39 taxmann.com 88 (Del)

¹⁶⁵ CIT Vs. Halliburton Export Inc. (ITA No. 363 and 365 of 2016); ADIT (IT) vs Baan Global BV [2016] 71 taxmann.com 213 (Mumbai - Trib.); Mc Kinsey Knowledge Centre India (P.) Ltd. vs ITO [2018] 92 taxmann.com 226 (Delhi - Trib.)

¹⁶⁶ DIT vs Nokia Networks OY [2012] 25 taxmann.com 225 (Del)

¹⁶⁷ DDIT vs. Reliance Communication Ltd. [2018] 90 taxmann.com 358 (Mum trib.)

right to use the software without any right to sub-license, transfer, reverse engineer, modify or reproduce the software. In this light, the SC examined various provisions of the Copyright Act, 1957 in force in India (ICA) and held that a limited right to use the software, make copies of the software for the purpose for which it was granted and without grant of rights of the copyright owner (such as reproduction, issuing copies, commercial exploitation), does not qualify as grant of a copyright under the ICA.

The SC noted that the definition of royalty under the Act, prior to amendment in 2012, as well as the DTAA's under consideration [which are similar/identical to the OECD Model Convention (MC)], necessarily requires grant of a copyright in software to the licensee for the payment to qualify as royalty. Since the payment made by end users and distributors did not involve payment for grant of any right specified under the ICA, payments made by the distributors and end users do not qualify as royalty under the DTAA, as well as the pre-amended provisions of the Act. Such payments qualify as business income not taxable in India under the DTAA.

In Cincom system Inc vs Deputy Director of Income Tax(IT) [2016] 71 taxmann.com 258 Delhi Tribunal

an Indian company paid towards gateway facilities provided by its US parent that would facilitate communication from India to people of the USA and vice versa which was done through embedded secret software owned by the assessee. The Delhi Bench of the ITAT held that the payments received from Indian company were royalty under Article 12(3)(a) of the India-USA DTAA since the use of the CPU and the consolidated data network of the American company is not merely "use of or the right to use any industrial, commercial or scientific equipment as envisaged in article 12(3)(a) of that Treaty but also the use of embedded secret software (an encryption product) developed by the American company for the purpose of processing raw data transmitted by the Indian company.

12.4.4 Divisibility of Contracts / Composite Agreements

Depending on case to case, a contract may be a composite or an indivisible contract, or a divisible contract. In case of an indivisible contract, the entirety of the transaction ought to be taken and the individual transactions get colligated under the main contract activity. In case of a divisible contract, taxability of each contract element is as per the relevant attributes of the element under consideration.

In DIT vs. Ericsson A.B.¹⁶⁸, the Delhi High Court held that the supply contract of a non-resident to an Indian Company of a GSM System including hardware and software is inseparable / not divisible separately so as to tax the software component as royalty and that the definition of royalty in the India- Sweden treaty is narrower than the Act and has to be considered and so no part of the payment can be classified as royalty. It affirmed the decision of Special Bench in Motorola Inc.¹⁶⁹ on similar issue of supply of GSM cellular equipment with hardware and embedded software which was held to be indivisible and non-taxable in India. Mumbai

¹⁶⁸ DIT vs Ericsson A.B. [2012] 204 Taxman 192 (Del)

¹⁶⁹ Motorola Inc vs DCIT [2005] 147 Taxman 39 (Del SB)

Tribunal¹⁷⁰ observed that in case of a sale of machine along with operating software, software had no other independent use, except to enable such machine to function. It held that there was no separate transaction of sale of software and, therefore, it was predominantly transaction of sale of machine which cannot be brought within the definition of royalty. For arriving at this conclusion, Tribunal relied on the decision of DIT vs. Ericsson (supra). In a recent ruling, Kolkata Tribunal¹⁷¹, while relying on the decision of Mumbai Tribunal in case of Galatea Ltd. (supra), held that in case of sale of equipment and its accessories with software imbedded in the equipment, one cannot bifurcate the consideration towards software so as to tax the amount as royalty.

Recently, Delhi Tribunal in the case of Bentley Nevada LLC¹⁷² held that when a software is embedded in hardware and there is one composite price, the entire amount remains as business income and a part of the same cannot be considered as royalty within the explanation 4 to section 9(1)(vi) of the Act.

12.4.5 Online Access to Database (subscriptions) and domain name registration

The underlying issue in such cases is whether the payments for subscription or access to an online database, reports, journals, e-zines etc. falls under the ambit of Royalty?

In the case of HEG¹⁷³ it was observed that every information, just because it is commercial in nature would not acquire the status of royalty. Some sort of expertise or skill would be required so as to qualify it as royalty.

In the case of Dun & Bradstreet Espana¹⁷⁴ the assessee was in the business of providing various products to businesses across the globe. One of their products was a business information report, which it was also selling to a group subsidiary in India. A business information report typically provided information in respect of a company on various aspects such as its existence, operations, financial condition, management's experience, line of business, facilities, etc. as also information about any suits, liens, judgments, etc. Based on a detailed analysis, the AAR concluded that sale of a business information report could be equated with the sale of a book (i.e. there is no transfer / grant of right to use the intellectual property rights associated with the book). Accordingly, payments received towards sale of a business information report cannot be characterized as "royalty" as defined in Article 13 of the India-Spain DTAA.

However, the Karnataka High Court in the case of Wipro Ltd.¹⁷⁵ held that though subscription access to journal may seem different from software license, it is nothing but a license to use ('right to use') the journal and hence, will come under royalty. However, Ahmedabad Tribunal¹⁷⁶ held that payment made to access online database couldn't be held as royalty as payment was

¹⁷⁰ Galatea Ltd. Vs. DCIT [2016]179 TTJ 265 (Mum)

¹⁷¹ HITT Holland Institute of Traffic Technology B.V. V.s DDIT [2017] 78 taxmann.com 101(Kol)

¹⁷² Bentley Nevada LLC vs. JDIT (ITA Nos.5817 to 5821/Del/2011, dated 31 January 2018)

¹⁷³ CIT vs HEG [2003] 130 taxmann 72 (MP)

¹⁷⁴ Dun & Bradstreet Espana S.A., In Re [2005] (272 ITR 99) (AAR)

¹⁷⁵ CIT vs Wipro Ltd. [2011] 203 taxman 621 (Kar)

¹⁷⁶ ITO vs. Cadila Healthcare Ltd [2017] 77 taxmann.com 309 (Ahmedabad Trib)

not for use of copyright of literary database but only for access to the literary database under the licence.

Thus, as can be seen from the above, the matter continues to be debatable.

Further, having regard to domain name registration, recently Delhi Tribunal in the case of Godaddy.com¹⁷⁷ has observed that a domain name is an intangible asset similar to a trademark relying on judgments of SC in the case of Satyam Infotech Ltd.¹⁷⁸ and Delhi HC in the case of Tata Sons Ltd.¹⁷⁹ The Delhi Tribunal held that payments received by Godaddy for services rendered in respect of domain name registration were in the nature of royalty and taxable as such within the meaning of clause (iii) of Explanation 2 to section 91(1)(vi) of the Act.

12.4.6 Supply of drawings, design etc.

The important issue in such cases is whether the transaction is that of a sale or royalty with regard being given to whether the seller / licensor retains the ownership rights in the property under consideration.

In the case of Davy Ashmore¹⁸⁰ consideration for outright sale of drawings and designs (where the non-resident seller does not retain any property in them) cannot be characterized as “royalty” as defined in Article 13 of the India-UK DTAA.

Similarly, in the case of Neyveli Lignite¹⁸¹, the total contract price paid to a foreign company towards designing, manufacture, supply, erection and commissioning of an equipment (not involving transfer of any license in a patent, invention, model or design) was not in the nature of “royalty” as defined in section 9(1)(vi) of the Act. The above conclusion was arrived at on the basis of the fact that the designs so provided were meant for the limited purpose of ensuring that the equipment met the special design requirements of the buyer (and accordingly, the sum so paid could not be construed as “royalty”).

12.4.7 Information concerning technical, industrial, commercial and scientific knowledge, experience or skill

The words “payment for information concerning industrial, commercial, or scientific experience” are used in context of that information which has not been patented and does not generally fall within the other categories of property rights. It generally consists of undivulged information of industrial, scientific or commercial nature arising from previous experience, which has practical application in operation of an enterprise and from the disclosure of which an economic benefit can be derived. Some illustrative cases in this category could be:

- Ideas / underlying source code / algorithms relating to software program developed by a software company.

¹⁷⁷ Godaddy.com LLC vs. ACIT [2018] 92 taxmann.com 241 (Delhi Trib.)

¹⁷⁸ Satyam Infoway Ltd. v. Sifynet Solutions (P.) Ltd. AIR 2004 SC 3540

¹⁷⁹ Tata Sons Ltd. v. Manu Kishori 90 [2001] DLT 659 (Delhi)

¹⁸⁰ CIT v/s Davy Ashmore India Ltd. [1991] (190 ITR 626) (Calcutta HC)

¹⁸¹ CIT vs Neyveli Lignite Corporation Ltd [2000] (243 ITR 459) (Madras)

- Making available database nurtured by commercial experience¹⁸²

12.5 Fees for Technical Services as per DTAA's

Article 12A of UN Model tax Convention, 2017 was added to allow a Contracting State to tax fees for certain technical services paid to a resident of the other Contracting State. Until the addition of Article 12A, income from services derived by an enterprise of a Contracting State was taxable exclusively by the State in which the enterprise was resident unless the enterprise carried on business through a permanent establishment in the other State (the source State) or provided professional or independent personal services through a fixed base in the source State.

Further, Indian DTAA's have a specific provision for taxing FTS which is dealt with in Article 12 along with Royalties.

Each specific DTAA would have a definition of the term FTS. There are certain peculiarities w.r.t. to definition of FTS in various DTAA's India has entered into:

- In most of the DTAA's for instance Thailand, Greece, Philippines, Syria, UAE, Saudi Arabia, Myanmar, Bangladesh, etc., there is no FTS clause either separately or included in the definition of Royalty. [Refer Para 12.5.2 for detailed discussion]
- In most of the DTAA's for instance Israel, Malaysia, Namibia, Oman, there are separate Article for Royalties and FTS.
- In some DTAA's such as with Austria, Belgium, China, Germany, Hungary, Netherlands etc. although FTS clause is present, there is no separate Article for "FTS". "Royalty" and "FTS" have been dealt with in the same Article itself. While in some DTAA's such as with Botswana, Kenya, Zambia the similar articles like Technical fees, Management and professional fees are used to cover FTS.
- In some DTAA's- Netherlands, Austria, Georgia, Armenia, Canada, Ireland, Russia, Germany, Japan the term "FTS" has been defined similar to the definition of FTS under the Act.
- While most of the DTAA's use the terminology "FTS", some DTAA's use the term "Fees for Included Services (FIS)" (E.g. India- US DTAA). Further, DTAA's with US and Canada characterize technical assistance as 'included services'.
- In some DTAA's- Australia, Netherlands, Canada, Spain, Portugal, UK, USA the scope of the term "FTS" includes only technical and consultancy services and does not embrace Managerial Services.[Refer Para 12.5.3]
- Some of the DTAA's for instance with USA, UK, Singapore, Netherlands have a restrictive definition of FTS requiring satisfaction of the "make available" criteria. [Refer Para 12.5.4]
- Some of the DTAA's such as France, Spain, Belgium, Switzerland, Sweden have a MFN

¹⁸² Cushman & Wakefield(S) Pte Ltd In Re [2008] 305 ITR 208 (AAR)

clause pursuant to which a restrictive meaning is accorded to FTS by importing the “make available” condition. [Refer Para 12.5.5 and para 10.2.9]

- DTAA with USA, UK, provide as to what is not to be regarded as FTS / FIS. Further, the DTAA that contain exclusion clause may also be worded differently so as to provide for different types of exclusions. Some of the DTAA provide for an exclusion of income under the clause on ‘Independent Personal Services’ and/or ‘Dependent Personal Services’. [Refer para 12.5.6]

12.5.1 Meaning / Definition of Fees for Technical Services

Fees for Technical Services is generally defined as:

“consideration for managerial or technical or consultancy services, including the provision of services of technical or other personnel.”

Thus, technical services comprise of following broad elements:

- Managerial Services
- Technical Services
- Consultancy Services
- provision of services of technical or other personnel

The terms “managerial”, “technical” and “consultancy” as appearing in the expression “FTS” have not been specifically defined in the Act. The Supreme Court in case of GVK¹⁸³ has held that general and common usage of the said words has to be understood at common parlance while interpreting the ambit of the term “FTS”. The discussion in the subsequent paragraphs elucidates further on each of the above components.

A. Managerial Services

The term ‘managerial services’ has been discussed in several judicial precedents and the broad principles emanating therefrom are discussed hereunder:

- The term “managerial” relates to “manager” or “management”. Further, a “manager” is a person who manages an industry or business or who deals with administration or a person who organizes other people’s activity¹⁸⁴.
- The term “management” includes the act of managing by direction, or regulation or superintendence¹⁸⁵.
- ‘Managerial service’ entails adoption and execution of various policies of an organization and is of permanent nature for the organisation as a whole¹⁸⁶.

¹⁸³ GVK Industries Ltd [2015] 371 ITR 453 (SC)

¹⁸⁴ Intertek Testing Services India Pvt. Ltd., [2008] 175 Taxman 375 (AAR)

¹⁸⁵ R Dalmia vs CIT [1977] 106 ITR 895 (SC)

¹⁸⁶ Linde A.G. vs ITO [1997] 62 ITD 330 (Mum ITAT)

- 'Managerial service' essentially involves controlling, directing or administering the business. When one talks of rendering 'managerial services' in relation to some activity, it is the management of such overall activity. Doing bits or small parts of overall activity independently here and there cannot be considered as rendering of a 'managerial service' in relation to such activity¹⁸⁷.

The Delhi High Court¹⁸⁸ relied on an article on "management sciences" in the Encyclopedia Britannica, wherein it was stated that "management" in organizations includes at least the following -

- Discovering, developing, defining and evaluating the goals of the organization and the alternative policies that will lead towards the goals;
- Getting the organization to adopt the policies;
- Scrutinizing the effectiveness of the policies that are adopted;
- Initiating steps to change policies when they are judged to be less effective than they ought to be.

B. Technical Services

It is a term of wide connotation and includes a range of services involving technical knowledge, assistance in technical operations, maintenance and other support in technical matters. It must be broadly construed to include any kind of service given by someone who is an expert in any subject such that various types of professional services would also be included within the scope.

The following judicial precedents have explained the term technical services:

- Services which are specialized, exclusive and customized to user/consumer qualify as "fees for technical services". "Technical services" like "Managerial and Consultancy service" would denote seeking of services to cater to the special needs of the consumer/user as may be felt necessary and the making of the same available by the service provider¹⁸⁹.
- Provision of technical assistance in preparation of drawings and designs¹⁹⁰.
- Payments made for pre-clinical studies¹⁹¹.
- Geological services¹⁹²

¹⁸⁷ Credit Lyonnais vs ADIT [2013] 35 taxmann 583 (Mum ITAT)

¹⁸⁸ J.K. (Bombay) Ltd. vs CBDT & UPI [1979] 118 ITR 312 (Del)

¹⁸⁹ CIT vs Kotak Securities Ltd. (2016) 239 Taxman 139 (SC)

¹⁹⁰ Central Mine, Planning & design Institute Ltd vs DCIT [1997] 67 ITD 195 (Patna ITAT)

¹⁹¹ Dr. Reddy's Research Foundation vs DCIT [2015] 68 SOT 47 (Hyderabad ITAT)

¹⁹² CIT vs De Beers India Minerals Pvt Ltd [2012] 208 taxman 406 (Kar)

- Automated analysis of a chemical compound cannot be a 'technical' service but a physical examination by an expert chemical analyst of the same chemical compound would be a 'technical' service¹⁹³.
- Payment for fees for standard services (cellular network, VSAT up linking, use of internet bandwidth) is not in the nature of FTS. The mere fact that the service provider has installed sophisticated equipment does not itself make it FTS. A technical service without human intervention would not be covered within the ambit of the definition of "FTS"¹⁹⁴ Payment towards data processing involved provision of a standard facility without any human intervention and would not constitute FTS¹⁹⁵ (The royalty angle associated with such payments is covered in para 12.4.2 above)

C. Consultancy Services

- Black's Law Dictionary, Eighth Edition defines 'consultation' as an act of asking the advice or opinion of someone (such as a lawyer). Based on the definition the Supreme Court observed that consultation means a meeting in which a party consults or confers and eventually it results in human interaction that leads to rendering of advice.
- 'Consultancy service' may overlap the categories of 'technical' and 'managerial' services to the extent the latter type of services are provided by a consultant.

The following judicial precedents have explained the term consultancy services:

- The Supreme Court has also referred to the observation of Delhi High Court¹⁹⁶ that the word "consultant" is a derivative of the word "consult" which entails deliberations, consideration, conferring with someone, conferring about or upon a matter. Service of consultancy necessarily entails human intervention. The consultant who provides the consultancy service, has to be a human being. A machine cannot be regarded as a consultant.
- Advisory service which merely involve discussion and advice of routine nature or exchange of information cannot appropriately be classified as consultancy services. An element of expertise or special knowledge on the part of the consultant is implicit in the consultancy services¹⁹⁷.
- Services constituting in the provision of advice by someone, such as a professional, who has special qualifications allowing him to do so¹⁹⁸.

¹⁹³ ITO vs Right Florists Pvt Ltd [2013] 143 ITD 445 (Kol ITAT)

¹⁹⁴ Expeditors International (India) Pvt. Ltd. Vs ACIT [2010] (2 ITR (Trib.)153) (Delhi ITAT); Skycell Communications Ltd. Vs DCIT [2001] (251 ITR 53) (Madras High Court), CIT vs. Estel Communications (P) Ltd. [2008] (318 ITR 185) (Delhi High Court); CIT v/s Bharti Cellular Ltd. [2011] (319 ITR 139) (Delhi High Court)

¹⁹⁵ Atos Information Vs. DCIT (ITA NO. 237,238,239 &240/MUM/2016), Mum ITAT

¹⁹⁶ CIT v. Bharti Cellular Ltd. [2009] 319 ITR 139. The SC has also ruled on this matter, [2011] 330 ITR 239

¹⁹⁷ Intertek Testing Services India Pvt. Ltd., [2008] (175 Taxman 375) (AAR)

¹⁹⁸ OECD TAG Report

- The word "consultancy" means giving some sort of consultation de hors the performance or the execution of any work. It is only when some consideration is given for rendering some advice or opinion etc. that the same falls within the scope of "consultancy services"¹⁹⁹.
- The consultancy should be rendered by someone who has special skills and expertise in rendering such advisory²⁰⁰.

D. Provision of Services of Technical or Other Personnel

In simple terms, the "provision of services of technical or other personnel" amounts to rendition of technical services. In this case, the service provider makes available the services of the personnel to the recipient of the services. Thus, services would be covered by Explanation 2 of section 9(1)(vii) of the Act, irrespective of whether these personnel renders 'managerial', 'technical' or 'consultancy' services.

There are certain important features which are generally present in the arrangement between the service provider and the service recipient for "provision of services of technical or other personnel":-

- The nature of work specifically states the number of personnel of the service provider whose services would be provided.
- The consideration of such services is based on the number of personnel provided.
- The person providing personnel may have an ongoing role to play.
- The recipient of services is responsible for the work performed by the personnel.
- The personnel provide services under the supervision and control of the service recipient.
- The person providing the personnel retains the right to remove/withdraw or replace.

The arrangement of "provision of services of technical or other personnel" must be distinguished with the arrangement of "provision of personnel". This can be explained with the help of the below cases:-

- In the case of a recruitment agency, the arrangement between the parties is such that the agency assists the other party in recruiting the personnel and the role of the recruitment agency ends once the personnel are hired. Thereafter, the personnel are on the payroll of the party and the recruitment agency does not retain any right over the personnel. The recruitment agency is paid for 'providing personnel' and not for the 'services of the personnel'.
- In distinction to the above case, where a computer professional firm sends its computer engineers to a company for continuous support, the firm can be said to 'provide services of technical personnel' and thus, the fees earned would be in the nature of FTS.

¹⁹⁹ UPS SCS (Asia) Ltd vs ADIT [2012] 18 taxmann.com 302 (Mum ITAT)

²⁰⁰ Le Passage to India Tours & Travel (P.) Ltd. vs DCIT [2014] 369 ITR 109 (Delhi ITAT)

Another aspect which merits attention is that the expression 'other personnel' does not include any personnel unrelated to managerial, technical or consultancy services²⁰¹.

12.5.2 Absence of Article on FTS in the DTAA

Typically, in DTAA's where FTS clause is present, the income gets taxed under the specific FTS clause unless the same is effectively connected to the PE, in which case it is taxed as Business Profits under Article 7 of the respective DTAA (Refer *further discussion in paragraph 12.7*).

In DTAA's where no FTS / FIS clause is present, an ambiguity arises as to whether:

- such income would be taxed under the Article dealing with 'Business Profits'; or
- under the residuary Article 'Other Income'; or
- would be taxed as per the provisions of the Act?

This issue is of significant importance to the Source State as classification of such income as 'Business Profits' may result in income not being taxed at all unless there is a PE in the source state.

There are divergent views on this issue:

- One view holds that in absence of FTS clause, the income would be governed under the Article 'Business Profits' and would be taxable in India only if the taxpayer had a PE in India²⁰². If income arises from normal business operations, it ought to be taxed under 'Business Profits' itself²⁰³.
- Another view holds that in absence of FTS clause, the taxability of the income needs to be evaluated under the 'Other Income' Article²⁰⁴.
- Yet another view holds that if a DTAA is silent on a particular type of income, such income cannot be automatically construed as 'Business Profits' and reference should be made to the provisions of the Act²⁰⁵.

Based on the judicial precedents and general rules of interpretation of the DTAA's, a view which is commonly adopted is that in absence of FTS clause in the DTAA, the income should not be taxed in India in absence of a PE of the non-resident recipient. The Bangalore Tribunal²⁰⁶, while dealing with various arguments mentioned above held that in the absence of the provision in the DTAA to tax Fees for Technical Services, the same would be taxed as per the Article 7 of

²⁰¹ ACIT vs Merchant Shipping Services (P) Ltd [2011] 129 ITD 109 (Mum ITAT)

²⁰² ACIT vs Viceroy Hotels Ltd. (2011) 46 SOT 4 (Hyd); Channel Guide India Ltd vs ACIT (2012) 20 ITR(T) 438 (Mum); Mckinsey & Co (Thailand) Co. Ltd. vs DDIT (2013) 36 taxmann.com 375 (Mum); Bangkok Glass Industry Co Ltd vs ACIT (2013) (257 CTR 326) (Mad)

²⁰³ DCIT vs Andaman Sea Food (P.) Ltd (2012) 22 taxmann.com 400 (Kol), DCIT Vs. Welspun Corporation Limited (ITA No. 48 and 249 (Ahd) of 2015)

²⁰⁴ Lanka Hydraulik Institute Ltd, In Re (2011) 199 taxmann 232 (AAR); XYZ, In Re (2012) 206 taxman 494 (AAR)

²⁰⁵ CIT vs TVS Electronics (2012) 22 taxmann.com 215 (Chennai)

²⁰⁶ ABB FZ-LLC vs. ITO [2017] 162 ITD 89 (Bang)

the DTAA. The nature of transaction as well as its nexus with the business activities of the service provider shall also play a pivotal role in determining the classification.

12.5.3 FTS Article embraces 'Technical' and 'Consultancy' Services

In some DTAA's, the scope of the term "FTS" includes only technical and consultancy services and does not embrace Managerial Services (E.g., India-USA DTAA). In case the services do not qualify as technical or consultancy services, it is possible to take a position that the payment is not covered within the purview of Article 12. Thus, the same qualifies as business income under Article 7 and would be taxed only if the non-resident has a PE in India.

Most of the DTAA's where managerial services are not included in the definition of FTS, contain 'make available' provision. In a few judicial precedents²⁰⁷, it has been held that managerial services being outside the purview of the definition of FTS, no part of the fees for 'managerial services' could be considered as fees for technical services and therefore could not be charged to tax.

12.5.4 Make Available

The expression 'make available' assumes great significance in the context of determining the taxability of payment of FTS. Some of the DTAA's which India has entered into with few countries viz. USA, UK, Singapore, Netherlands, Cyprus etc. contain a more restrictive definition of FTS / FIS as it requires satisfaction of the 'make available' condition with respect to such services. The DTAA's which contain 'make available' clause provide that fee for technical services paid by a resident to non-resident shall be liable to tax in India only if such services 'make available' technical knowledge, experience, skill, know-how, or processes or consist of the development and transfer of a technical plan or technical design. The presence of this clause limits the scope as well as the taxability of such services in the Source State.

In simple terms, mere rendition of services does not fall within the gamut of the expression 'make available' unless the following conditions (illustrative) are fulfilled:-

- The technical knowledge, skills, etc. remain with the person receiving the services even after the agreement comes to an end.
- The technical knowledge or skills of the provider are imparted to the recipient.
- The recipient is in a position to deploy similar skills or technology or techniques in future without the aid or assistance of the service provider.
- The technical information which is imparted or transmitted remains at the disposal of the recipient for taking benefit therefrom.

A distinction needs to be made between services which are rendered and services which are made available. While all services that are made available are necessarily rendered, not all services that are rendered, 'make available' the technical knowledge, skill, etc. to enable the recipient to derive an enduring benefit and apply the technology contained therein.

²⁰⁷ Raymonds Ltd vs DCIT (2003) 80 TTJ 120 (Mum)

The expression 'make available' has not been defined in any of the DTAA's except for the India-USA DTAA. The explanation provided in the Memorandum of Understanding ('MOU') appended to the India-USA DTAA is as follows:

"Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not per se mean that technical knowledge, skills, etc., are made available to the person purchasing the service, within the meaning of paragraph 4(b). Similarly, the use of a product which embodies technology shall not per se be considered to make the technology available." (Emphasis supplied)

The MOU even lists down certain services wherein technology is made available. The specified illustrative services include bio-technical services, environmental and ecological services, food processing, geological surveys, scientific services, technical training etc. The concept of 'make available' has been very well explained with the aid of illustrations in the India-USA DTAA and has been appended in **Annexure-I**

While it may be correct to say that the MOU relating to India-USA Treaty would not apply to any other treaty, but when the expression has been interpreted and explained in a way that is consistent with the meaning attributed to it, the explanation does become a valuable aid for interpretation.

Various judicial precedents have held that 'make available' is a condition precedent for invoking the clause for FTS / FIS. Since the connotation 'make available' is not specifically defined either under the Act or in the DTAA's, recourse to the available judicial precedents shall have to be made while adopting a view as to whether services are made available or not.

Illustrative Examples of Income categorised as FTS / FIS (upon satisfaction of 'make available' criteria)

- Technical assistance to enable recipient to design, construct and operate a plant to manufacture and training for application of technical knowhow²⁰⁸
- Management Services, training etc. relating to software development business were technical in nature.²⁰⁹

Illustrative Examples of Income not categorised as FTS / FIS (on the basis of 'make available' criteria)

- Repair of software²¹⁰
- Surveillance for the purpose of ISO Certification²¹¹

²⁰⁸ Foster Wheeler France S.A vs. DDIT [2016] 67 taxmann.com 120

²⁰⁹ US Technology Resources (P.) Ltd. vs ACIT [2013] 39 taxmann.com 23 (Coch ITAT)

²¹⁰ Airport Authority of India, In Re [2005] 273 ITR 437 (AAR)

²¹¹ NQA Quality Systems Registrar Ltd vs DCIT [2005] 2 SOT 249 (Del ITAT)

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- Marketing and Management services²¹²
- Supply Management Services²¹³
- General training not involving any transfer of technology²¹⁴
- Supervisory services did not enable the recipient to use the services without involvement of the service provider and hence did not fall within the purview of FTS²¹⁵

Whether the concept of 'make available' can be applied to 'development and transfer of the technical plan or technical design'

This question came up for consideration in the case of **SNC-Lavalin International Inc. Vs DDIT, IT, Delhi [2008] 26 SOT 155 (Delhi)**. The ITAT in this case held as under: “Thus, if the payment for rendering any technical or consultancy service is “fees for include services”, if such services either make available technical knowledge, experience, skill, know-how or process or consists of the development and transfer of the technical plan or technical design. When the payment is for development and transfer of a technical plan or technical design, it need not be coupled with the condition that it should also make available technical knowledge, experience, skill, know-how or process etc. The word 'make available' goes with technical know-how experience, skill, know-how or process etc. But do not go with “constraints of the development and transfer of a technical plan or technical design”. The second limb in clause (b) of sub-article (4) of article 12 of DTAA can be invoked when the amount is paid in consideration for rendering of any technical or consultancy services and if such services consists of the development and transfer of a technical plan or a technical design also. By the way, the condition of making available technical knowledge is not sine qua non for considering the question as to whether the amount is fees for included services or not particularly when the payment is only where the technical or consultancy services consists of development and transfer of a technical plan or technical design only. This will be considered as “fees for included services” within the meaning of Article 12(4) of the Act and hence, in terms of /article 12(2) tax rate should be charged”.

The above view of the ITAT has been upheld by the Delhi High Court, reported in Director of Income tax v. SNC Lavalin International Inc. [2011] 332 ITR 314/199 Taxman 247/11 taxmann.com 23 (Delhi).

1) Application of Make available Concept to various categories of Services:

IT support services- One of the common picked up issues by the revenue to contend that payments made towards IT services would tantamount to fee for technical service.

Sandvik Australia Pty. Ltd. Vs. Dy. DIT(IT) [2013] 31 taxmann.com 256/141 ITD 598 (Pune tribunal). (India-Australia Treaty) - The ITAT held that “In the present case as per the terms of

²¹² WNS North America Inc vs ADIT [2012] 28 taxmann.com 173 (Mum ITAT), Bativala & Karani Securities (India) (P.) Ltd. vs. DCIT (2016)(159 ITD 924)(Kol)

²¹³ Cummins Ltd., In Re(2016)(237 Taxman 693)(AAR)

²¹⁴ ITO vs Veeda Clinical Research (P.) Ltd [2013] 35 taxmann.com 577 (Ahmd ITAT)

²¹⁵ Outotec India (P.) Ltd vs ACIT [2015] 59 taxmann.com 108 (Del ITAT)

the agreement between the assessee company and Sandvik Asia Ltd does not support the case of the revenue that the assessee case is covered in clause (g) of para 3 to Article 12 of the India-Australia Treaty as the assessee has not made available any technical knowledge or expertise to the recipient Indian company. In our opinion, the assessee has only provided the back-up services and IT support services for solving IT related problems to its Indian subsidiary. Hence, unless and until the services are made available, same cannot be taxable in India. We, therefore hold that the services rendered by assessee company to its Indian group companies, though are in the nature of technical services, but is not covered in para (3)(g) to Article 12 of the India-Australia Treaty and hence, the same is not taxable in India”.

2) Market support services/ Business development

DIT(IT) vs. hrosystems India (P.) Ltd. [2014] 48 taxmann.com 93/227 taxman 117/369 ITR 63 (Kar. -HC) (India- Singapore Treaty)

From the facts of this case, it is clear that Sun Singapore has not made available to the assessee the technology or the technological services which is required to provide the distribution, management and logistic services. That is a finding of fact recorded by the Tribunal on appreciation of the entire material on record. When once factually it is held the technical services has not been made available, then in view of the law declared in the aforesaid judgement, there is no liability to deduct tax at sources and therefore, the finding recorded by the Appellate Authority cannot be found fault with.

3) Whether Managerial services would be covered under the purview of “Fees for technical service”

a) *Dy. CIT(IT) vs. Hyva Holding B.V. (ITA 3816/Mum/2017 dated April 30, 2019)/[2019] 106 taxmann.com 24 (Mum. Tribunal) (India – Netherlands Treaty)*

In the aforesaid ruling the Mumbai tribunal has taken the view that where the assessee made payments to a Netherlands entity for providing services principally in the nature of managerial services, even though the same had some trappings of technical or consultancy services, no tax at source would be required to be deducted in view of the fact that “Managerial services are excluded from the purview of Technical services in India- Netherlands Treaty. The Tribunal even noted that even the AO could not attribute any amount to technical services or Consultancy services.

12.5.5 Most Favoured Nation

India has entered into DTAA's having a Most Favoured Nation clause with various countries²¹⁶. The Protocol to the DTAA's with said countries ('relevant DTAA') provide that if under any DTAA between India and a third State ('subsequent DTAA'), India limits its taxation to a lower rate or a more restricted scope than the rate or scope provided in the relevant DTAA, the same rate or scope as is applicable in the subsequent DTAA shall also apply under the relevant DTAA.

²¹⁶ Netherlands, France, Spain, Belgium, Switzerland, Sweden, Finland, Hungary, etc. MFN Clause in India's DTAA with Kazakhstan has been deleted with effect from 01 April 2018.

Thus, in simple terms MFN clause is a provision in the DTAA by which one state agrees to accord to the other State a treatment that is no less favourable than that which it accords to the third States. It may be pertinent to note that the MFN clauses present in the Protocol of the DTAA's are differently worded. A typical MFN clause in any Indian DTAA reads as under –

“In respect of Articles 10 (Dividends), 11 (Interest) and 12 (Royalties and Fees for Technical Services) if under any Convention, Agreement or Protocol between India and a third State which is a member of the OECD, India limits its taxation at source on dividends, interest, royalties, or fees for technical services to a rate lower or a scope more restricted than the rate or scope provided for in this Convention on the said items of income, the same rate or scope as provided for in that Convention, Agreement or Protocol on the said items of income shall also apply under this Convention.”

Thus, in view of the above, while examining the tax liability of Royalty / FTS under the relevant provisions of the DTAA, it would also be critical to examine whether the DTAA has a 'most favoured nation' clause or not²¹⁷.

12.5.6 Exclusions to the definition of FTS

While some of the DTAA's such as Belarus, Czech Republic, Hungary, Ireland, Russia etc. provide for an exclusion of payments made for services under the clause on 'Independent Personal Services' and 'Dependent Personal Services', in other DTAA's such as China, Germany, South Africa etc., only payments under the clause 'Independent Personal Services' are excluded from the purview of the Article 12.

Thus, where Article 12 specifically excludes income covered under Article 14 and Article 15 from its purview, to that extent provisions of Article 12 and 14/15 are mutually exclusive. However, it is possible that Article 12 of the DTAA's do not expressly provide for exclusion of income under Article 14/15. E.g. In the case of professional fees paid to non-residents who are individuals or firms, it is likely that the taxability shall be governed by the Article dealing with Independent Personal Services, wherein the amount would be taxable if the non-resident performs such services from a fixed base in India and his duration of stay in India exceeds specified number of days (conditions needs to be evaluated based on the relevant provisions of the DTAA). In such cases, the judicial view²¹⁸ is that “If there is an apparent conflict between two independent provisions of law, the special provision must prevail.”

A few DTAA's such as USA, Canada, Singapore provide for certain exclusions from the scope of FIS. Article 12(5) of the India-USA DTAA is an exclusion clause which restricts the scope of applicability of the FIS. The following are excluded:

- Amounts that are ancillary and subsidiary as well as inextricably and essentially linked to sale of property. To determine whether the service is ancillary and subsidiary as well as inextricably and essentially linked to sale of property is a fact intensive exercise. In

²¹⁷ Also refer para 10.2.9.

²¹⁸ Union of India vs. India Fisheries (P) Ltd. [57 ITR 331 (1965)](SC); ITO vs. Titagarh Steels Ltd [79 ITD 532 (2001)](Kol ITAT)

common parlance, fees would be considered as 'ancillary and subsidiary' if the service is directly related or is incidental or complimentary to the application or enjoyment of the right, property. Services are said to be 'inextricably and essentially linked' to sale of property if such services are integral or necessary to facilitate the enjoyment of the property and without such services the property may be of little value to the purchaser.

- Services which are ancillary and subsidiary to the rental of ships, aircraft, containers etc. in connection with operation of ships or aircraft in international traffic are omitted from the definition of FTS. Since main activity (i.e. services in connection with operation of ships / aircrafts) are taxable in the state of fiscal domicile by virtue of provisions of the DTAA, similar principles should be extended to activities which are ancillary and subsidiary to the main activity.
- Amounts paid for teaching 'in' or 'by' educational institutions are excluded from the definition of FTS. However, arrangements where teaching is not the primary intention but only an incidental or ancillary objective, shall not be outside the purview of this exclusion.
- Amounts paid for services for the personal use of the individual(s) making the payments are excluded from the scope of the FTS.
- Amounts paid for professional services falling within the clause for 'independent personal services' shall not be included in the scope of FTS as both the provisions are mutually exclusive.

12.6 FTS as per the Act

As per provisions of section 9(1)(vii) of the Act , income by way of 'fees for technical services' of the following types will be deemed to accrue or arise in India:

- Fees for technical services payable by the Central Government or any State Government
- Fees for technical services payable by a resident, except where the payment is relatable to a business or profession carried on by him outside India or to any other source of his income outside India.
- Fees for technical services payable by a non-resident if the payment is relatable to a business or profession carried on by him in India or to any other source of his income in India.

Explanation 2 to section 9(1)(vii) of the Act with respect to FTS provides:

"fees for technical services mean any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'".

Paraphrasing the above, FTS is the consideration payable

- for **rendition**²¹⁹ of **managerial, technical or consultancy services**
- **including** provision of services of technical or other personnel
- but **does not include**
 - consideration for construction, assembly, mining or like project undertaken by the recipient; or
 - consideration which would be income of the recipient under the head “salaries”.

12.6.1 Exclusions from the Definition of FTS

The definition of FTS as contained in Explanation 2 to section 9(1)(vii) of the Act excludes consideration for any construction, assembly, mining or like project and consideration which would be chargeable as services.

From the expression 'or like project' it is evident that the exclusion clause definition is illustrative, rather than exhaustive. Therefore, even though this exclusion clause does not make a categorical mention about 'installation, commissioning or erection' of plant and equipment, belonging to the same genus as 'assembly' and are also covered by this exclusion clause.²²⁰

In light of the above discussion, once the payment is identified as Royalty / FTS, it is imperative to ascertain whether the same will be taxed as per Article 12 or as business profits under Article 7 read with Article 5.

12.7 Royalty / FTS vs Business Income

This aspect is typically dealt with in Article 12(4) of the UN Model. Various payments open a considerable scope for debate with regard to whether such payments constitute royalty under Article 12 of the tax treaty or service payments giving rise to business profits within the meaning of Article 7 of the tax treaty. In this context, it must be noted that if the following conditions are satisfied, the royalty / FTS shall be taxed as business profits in Article 7 and not in Article 12:

- Royalties arise in state S
- The beneficial owner of royalties is a resident of contracting state (State R)
- Such beneficial owner carries on business in state S through a PE situated therein or performs independent personal services from a fixed base situated therein and
- the right or property in respect of which royalty is paid is effectively connected to such PE

The above conditions are required to be satisfied on a cumulative basis. It is very important that the PE should be situated in a contracting state and not in a third state for Article 7 to apply. In all other cases, Article 12 would overrule Article 5 read with Article 7 of the DTAA.

²¹⁹ Standby annual maintenance charges are not FTS as there is no actual rendering of services - Flag Telecom Group Ltd. vs. DCIT [2015] 54 taxmann.com 154 (Mumbai ITAT)

²²⁰ Birla Corporation vs. ACIT [2015] 53 taxmann.com 1 (Jabalpur ITAT)

12.8 Concept of Beneficial Ownership

The concept of 'beneficial ownership' is one of the safeguards provided in the DTAA's to prevent treaty shopping and is applicable in situation where the source of income is in one country and the recipient of certain incomes is in other country. This concept of beneficial ownership is not only applicable to Royalty / FTS, but also applies to Interest and dividend income.

The term 'beneficial owner/ownership' is not defined in the DTAA's. Prof Klaus Vogel has explained the same as:

"The 'beneficial owner' is he who is "free to decide-

- i. Whether or not capital assets should be used or made available for use by others; or*
- ii. How the yields there from should be used; or*
- iii. Both."*

Article 12 provides that such income shall be taxed in that state of which the beneficial owner of the income is resident. The concept of 'beneficial ownership' is also used to grant the benefit of reduced treaty taxes.

The India-Australia DTAA uses the expression 'beneficially entitled' as against 'beneficial owner'. There are some DTAA's (Zambia, Kenya, Greece, Libya etc.) which do not embrace the concept of 'beneficial ownership' in this Article at all.

12.9 Concept of effectively connected

While the effective connection of royalties with a PE has to be evaluated by applying the "asset test", for FTS, the "activity test" or "functional test" should be applied²²¹. In the context of FTS, the concept of 'effectively connected' has been judicially interpreted to mean that PE should have some role in carrying out of technical services and not when PE is set up for a completely different purpose. The PE should be engaged in performance of technical services or should be involved in actual rendering of services.

There cannot be an effective connection when PE in State S becomes functional post the performance of "off shore services" which give rise to FTS even if such services are essential for the project execution.²²²

12.10 Tax treatment of Royalty / FTS

12.10.1 As per the provisions of the Act

The Act prescribes the methodology for computing income under the head "royalty" and "FTS". The same would vary depending on whether the non-resident has a PE / fixed place of profession in India or not.

²²¹ Iveco Spa Vs. ADIT [2016] 72 taxmann.com 195 (Del ITAT)

²²² (AAR in the case of Worley Parsons - [2009] 312 ITR 273 and ITAT Delhi in the case of Sumitomo Corpn v DCIT - [2007] 110 TTJ 302)

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Applicability of section 115A of the Act

- Where the non-resident does not have a PE / fixed place of profession in India to which the royalty / FTS income is effectively connected.
- In such a scenario, the royalty / FTS would be taxable on gross basis (i.e., without allowing any deduction for expenses incurred). The applicable tax rates would be 10%²²³ plus applicable surcharge and cess.

Applicability of section 44DA of the Act

- Where the non-resident has a PE / fixed place of profession in India to which the royalty / FTS income is effectively connected.

Royalty / FTS received by a non-resident from the Government / Indian concern under agreements entered after 31st March, 2003 and effectively connected to a PE / fixed place of profession in India would be computed under the head “business income”. Accordingly, income would be arrived at after reducing permissible expenses as per provisions of the Act.

- In computing this income, no deduction shall be allowed for –
 - Expenditure which is not wholly and exclusively incurred for the business of the PE / fixed place of profession in India; or
 - Amount paid by the PE to head office / any of its other offices (other than actual reimbursement of expenses).
- Further, the non-resident would be required to compulsorily maintain books of accounts as per section 44AA of the Act and get the accounts audited.
- The tax rate applicable under section 44DA of the Act is 40% (plus applicable surcharge and education cess).

Further, if the royalty / FTS is received from a non-resident (i.e., not from the Government or an Indian concern), the applicable tax rate would be 40% (plus applicable surcharge and education cess). However, in such a scenario, the benefit of net basis of taxation would be available.

A general principle that must be kept in perspective is that provisions of sections 9(1)(vi) and 9(1)(vii) of the Act deal specifically with royalty and FTS, respectively. Accordingly, given that a specific provision would override a generic provision, section 9(1)(i) of the Act should not be applied in circumstances where a particular income qualifies as “royalty” or “FTS” but is not taxable by virtue of any specific exclusion. This view is duly supported by certain judicial precedents²²⁴ as well.

12.10.2 As per the provisions of DTAA

The applicable article of the DTAA (i.e., Article 12 / 13 in most cases) would generally prescribe a rate for taxability of royalty / FTS / FIS covered within its fold. Similar to the treatment provided

²²³ As per Finance Act 2015, w.e.f. 1.4.2016

²²⁴ CIT vs. Copes Vulcan Inc. [1985] (167 ITR 884) (Madras HC) and Meteor Satellite Ltd vs. ITO [1979] (121 ITR 311) (Gujarat HC).

in section 115A of the Act, royalty or FTS / FIS not attributable to a PE in India of the non-resident recipient would be taxable on gross basis (as per relevant provisions of the DTAA). Most DTAA's India has entered into provide for a tax rate in the range of 10-15%²²⁵. In such a scenario, the assessee has an option to apply the tax rate prescribed in the applicable DTAA or section 115A of the Act, whichever is more beneficial to it.

Further, in a situation where the royalty / FTS is attributable to a PE in India of the non-resident, the income liable to tax would be computed on net basis as per relevant Articles of the DTAA (i.e., Article 5 {dealing with PE} read with Article 7 {dealing with Business Profits} in most cases). The tax rate applicable in such a scenario would be 40% (plus applicable surcharge and education cess).

In general, the determination of profits attributable to a PE in India is a complex exercise. A detailed FAR Analysis (Functions performed, Assets used and Risk assumed) would have to be conducted in this regard.

References

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- Taxmann - Indian Double Taxation Agreements and tax Laws - DP Mittal (2014)
- Technical Guide on Royalty and Fees for Technical Services – ICAI (Second Edition)
- International Taxation- A Compendium (CTC Third Edition)

²²⁵ Surcharge and education cess would not be leviable on such a rate.

Annexure 1

EXAMPLES GIVEN IN THE MEMORANDUM OF UNDERSTANDING CONCERNING FEES FOR INCLUDED SERVICES IN U.S. - INDIA TAX TREATY

Example 1

Facts:

A U.S. manufacturer grants rights to an Indian company to use manufacturing processes in which the transferor has exclusive rights by virtue of process, patents or the protection otherwise extended by law to the owner of a process. As part of the contractual arrangement, the U.S. manufacturer agrees to provide certain consultancy services to the Indian company in order to improve the effectiveness of the latter's use of the processes. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payment allocable to such services do not form a substantial part of the total consideration payable under the contractual arrangement. Are the payments for these services fees for "included services"?

Analysis:

The payments are fees for included services. The services described in this example are ancillary and subsidiary to the use of manufacturing process protected by law as described in paragraph 3(a) of Article 12 because the services are related to the application or enjoyment of the intangible and the granting of the right to use the intangible as the clearly predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered for included services under paragraph 4(a) of Article 12, regardless of whether the services are described in paragraph 4(b).

Example 2

Facts:

An Indian manufacturing company produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial or other harmful deposits. A U.S. company has developed a special cleaning process for removing such deposits from that type of machinery. The U.S. company enters in to a contract with the Indian company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the U.S. company leases to the Indian company a piece of equipment which allows the Indian company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required. Are the payments for the services fees for included services?

Analysis:

In this example, the provision of cleaning services by the U.S. company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services

might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4(a).

Paragraph 4(b)

Paragraph 4(b) of Article 12 refers to technical or consultancy services that make available to the person acquiring the services, technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plant or technical design to such person. (For this purpose, the person acquiring the service shall be deemed to include an agent, nominee, or transferee of such person). This category is narrower than the category described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service. Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not per se mean that technical knowledge, skills, etc., are made available to the person purchasing the service, within the meaning of paragraph 4(b). Similarly, the use of a product which embodies technology shall not per se be considered to make the technology available.

Typical categories of services that generally involve either the development and transfer of technical plants or technical designs, or making technology available as described in paragraph 4(b), include:

1. Engineering services (including the sub-categories of bio-engineering and aeronautical, agricultural, ceramics, chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);
2. Architectural services; and
3. Computer software development.

Under paragraph 4(b), technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for examples, relate to any of the following areas:

- (a) Bio-technical services ;
- (b) Food processing ;
- (c) Environmental and ecological services ;
- (d) Communication through satellite or otherwise ;
- (e) Energy conservation ;
- (f) Exploration or exploitation of mineral oil or natural gas ;
- (g) Geological surveys ;
- (h) Scientific services ; and
- (i) Technical training.

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The following examples indicate the scope of the conditions in paragraph 4(b):

Example 3

Facts:

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services"?

Analysis:

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill and processes.

Example 4

Facts:

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services?

Analysis:

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., are made available to the Indian company, nor is there any development and transfer of a technical plant or design. The U.S. company is merely performing a contract manufacturing service.

Example 5

Facts:

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to assess the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services?

Analysis:

The fees are for included services. The U.S. company clearly performs a technical service for the Indian company, and it transfers to the Indian company the technical plan (i.e., the computer programme) which it has developed.

Example 6

Facts:

An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis:

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example 7

Facts:

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product worldwide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis:

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of paragraph 4(b).

Paragraph 5

Paragraph 5 of Article 12 describes several categories of services which are not intended to be treated as included services even if they satisfy the tests of paragraph 4. Set forth below are examples of cases where fees would be included under paragraph 4, but are excluded because of the conditions of paragraph 5.

Example 8

Facts:

An Indian company purchases a computer from a U.S. computer manufacturer. As part of the purchase agreement, the manufacturer agrees to assist the Indian company in setting up the computer and installing the operating system, and to ensure that the staff of the Indian company is able to operate the computer. Also, as part of the purchase agreement, the seller agrees to provide, for a period of ten years, any updates to the operating system and any training necessary to apply the update. Both of these service elements to the contract would qualify under paragraph 4(b) as an included service. Would either or both be excluded from the category of included services, under paragraph 5(a), because they are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the computer?

Analysis:

The installation assistance and initial training are ancillary and subsidiary to the sale of the computer, and they are also inextricably and essentially linked to the sale. The computer would be of little value to the Indian purchaser without these services, which are most readily and usefully provided by the seller. The fees for installation assistance and initial training, therefore/are not fees for included services, since these services are not the predominant purpose of the arrangement.

The services of updating the operating system and providing associated necessary training may well be ancillary and subsidiary to the sale of the computer, but they are not inextricably and essentially linked to the sale. Without the upgrades, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer.

Example 9

Facts:

An Indian hospital purchases an X-ray machine from a U.S. manufacturer. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in India, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray film or techniques which could improve the effectiveness of the machine, and training hospital staff in the application of those new developments. The cost of the initial installation, inspection, training and warranty service is relatively minor as compared with the cost of the X-ray machine. Is any of the services described here ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine?

Analysis:

The initial installation, inspection, and training services in India and the periodic service during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on the service, the manufacturer has full responsibility during this period and this cost of the services is a relatively minor component of the contract. Therefore, under paragraph 5(a) these fees are not fees for included services, regardless of whether they otherwise would fall within paragraph 4(b).

Neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial purchase of the X-ray machine. Accordingly, fees for these services may be treated as fees for included services if they meet the tests of paragraph 4(b).

Example 10

Facts:

An Indian automobile manufacturer decides to expand into the manufacturer of helicopters. It sends a group of engineers from its design staff to a course of study conducted by the Massachusetts Institutes of Technology (MIT) for two years to study aeronautical engineering. The Indian firm pays tuition fees to MIT on behalf of the firm's employees. Is the tuition fee a fee for an included service within the meaning of Article 12?

Analysis:

The tuition fee is clearly intended to acquire a technical service for the firm. However, the fee paid is for teaching by an educational institution, and is, therefore, under paragraph 5(c), not an included service. It is irrelevant for this purpose whether MIT conducts the course on its campus or at some other location.

Example 11

Facts:

As in Example 10, the automobile manufacturer wishes to expand into the manufacturer of helicopters. It approaches an Indian university about establishing a course of study in aeronautical engineering. The university contracts with a U.S. helicopter manufacturer to send an engineer to be a visiting professor of aeronautical engineering on its faculty for a year. Are the amounts paid by the university for these teaching services fees for included services?

Analysis:

The fees are for teaching in an educational institution. As such, pursuant to paragraph 5(c), they are not fees for included services.

Example 12

Facts:

An Indian wishes to install a computerized system in his home to control lighting, heating and air-conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring system, adapt standard software, and provide instructions for installations. Are the fees paid to the American firm by the Indian individual fees for included services?

Analysis:

The services in respect of which the fees are paid are of the type which would generally be treated as fees for included services under paragraph 4(b). However, because the services are for the personal use of the individual making the payment, under paragraph 5(d) the payments would not be fees for included services.

12.11 Income from automated digital services

Article 12B has been added to the United Nations Model Convention in 2021 to enable taxation of digital transactions by the source country. The Article is reproduced at pages **3,94 to 3.105 in this Module**.

In the recent time, apart from continuation of globalisation of the world economies, there has been digitalisation of businesses. Digital technology has had a very significant impact on how cross-border business activities can be carried out at a very large scale, with high speed and without necessarily having a physical presence in the market jurisdiction (source jurisdiction). The question has arisen whether the existing rules under tax treaties allocating taxing rights amongst countries based on permanent establishment criteria are any longer appropriate in respect of the new business models based on digital technologies. The concept of permanent establishment effectively acts as a threshold and only where this threshold is met, is any taxation in the market jurisdiction possible under most of the existing tax treaty rules. The concept of permanent establishment in Article 5 is essentially based on a fixed place of business, and also includes service or construction activities carried on for a specific duration, the existence of a dependent agent and the collection of insurance premiums. However, with the advent of modern means of telecommunications and the spread of digitalization, enterprises have the ability to effectively engage in substantial business activities in the market country without a fixed place of business there, or to conclude contracts remotely through technological means with no involvement of individual employees or dependent agents.

Tax consequences of digitalized economies, especially from the point of view of developing countries were therefore recognized as a matter of importance by the UN. Consequently, Article 12B was added to the United Nations Model Tax Convention in 2021 to preserve the domestic law taxing rights for States from which payments for automated digital services are made.

Article 12B allows a Contracting State to tax income from certain digital services paid to a resident of the other Contracting State on a gross basis at the rate negotiated bilaterally and

specified in paragraph 2 of the Article with an option for the taxpayer to pay tax on a net profit basis for the whole year under paragraph 3 of the Article. Under Article 12B, a Contracting State is entitled to tax payments for automated digital services if the income is paid by a resident of that State or by a non-resident with a permanent establishment or fixed base in that State and the payments are borne by the permanent establishment or fixed base. Automated digital services are defined to mean services provided on the Internet or digital or other electronic network requiring minimal human involvement from the service provider. Until the addition of Article 12B, income from automated digital services derived by an enterprise of a Contracting State (unless it also fell within the scope of Articles 12 or 12A) was taxable exclusively by the State in which the enterprise was resident unless the enterprise carried on business through a permanent establishment in the other State (the source State) or provided professional or independent personal services through a fixed base in the source State and the income from automated digital services was effectively connected with such permanent establishment or fixed base.

Article 12B allows payments in consideration for the automated digital services to be taxed by a Contracting State on a gross basis. Many developing countries have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income from automated digital services derived by non-residents. A withholding tax imposed on the gross amount of payments made by residents of a country, or non-residents with a permanent establishment or fixed base in the country, is well established as an effective method of collecting tax imposed on non-residents. Such a method of taxation may also simplify compliance for enterprises providing such services in another State, since these enterprises would not be required to compute their net profits or file tax returns, unless they opt for net income basis taxation.

Article 12B does not require any particular threshold, such as a permanent establishment, fixed base, or minimum period of presence, in a Contracting State as a condition for the taxation of income from automated digital services. In this regard, modern methods for the delivery of services allow non-residents to render substantial services for customers in the other country with little or no presence in that country. The gross basis taxation is justified on the basis of the fact that it is possible to derive income from a country with little or no physical presence in that country.

No unanimity has been reached among the members of UN regarding methodology for taxing digital transactions.

In case income from automated digital service falls within the purview of both Article 12B and Article 7, the provisions of Article 12B prevail pursuant to paragraph 6 of Article 7. However, this priority given to Article 12B does not apply if the beneficial owner of the income from automated digital services carries on business through a permanent establishment in the Contracting State in which the income arises and the income from those services is effectively connected with the permanent establishment or business activities referred to in paragraph 1(c) of Article 7. In this situation, paragraph 8 of Article 12B provides that the provisions of Article 7 apply instead of Article 12B.

In order to reduce uncertainty and inconsistencies, paragraph 7 also explicitly clarifies that the Article does not apply to income from automated digital services where such income also qualifies as a “royalty” or as a “fee for technical services” falling under Article 12 or 12A, as the case may be.

Due to the nature of automated digital services, it is unlikely that income from automated digital services would be dealt with in both Article 12B and Article 14. Nevertheless, to avoid uncertainty, both paragraphs 2 and 3 explicitly provide that Article 12B applies to income derived from automated digital services also falling within the scope of Article 14. However, if the beneficial owner of the income performs independent personal services in the Contracting State in which the income from automated digital services arises through a fixed base situated in that State and the income from automated digital services is effectively connected with the fixed base, paragraph 8 of Article 12B provides that the provisions of Article 14 would apply instead of Article 12B.

13. Article 13 –Capital Gains

13.1 Introduction

In common parlance, income of an assessee can generally be classified as (a) income from revenue sources and (b) capital income. Income from revenue sources is generally generated through sale of goods or provision of services and is usually recurring in nature, whereas capital income generally arises on transfer of an asset or capital.

The Indian Income-tax Act, 1961 (‘the Act’) defines the term “capital asset” and in most situations, gains on ‘transfer’ of such assets are chargeable to tax in India.

In case of jurisdictions other than India, taxation of capital income varies considerably from country to country. In some countries, capital gains are taxable as ordinary income; in some countries, it is subjected to special rate of tax, whereas in some other countries there is taxation even on capital appreciation without actual transfer of the asset. Therefore, there is no consistent approach amongst various countries for taxation of capital income.

In the foregoing chapter, taxation of capital income, popularly known as capital gains, will be discussed under the DTAA that India has signed with various countries.

13.2 Capital gains under the Act

We have briefly discussed the taxability of capital gains under the Act which will help understand the differences between the DTAA and the Act.

The relevant provisions for taxation of income arising out of transfer of capital assets are covered under the provisions of sections 45 to 55A of the Act.

Income from Capital gains under the Act has been characterized into short-term capital gains and long-term capital gains. Where the asset is held for less than 3 years, it is short-term and for more than 3 years, it is called long-term. In case of shares, subject to conditions, the period

for short-term is reduced to 1 year. In order to qualify as long-term, the holding period is 2 years for unlisted shares (w.e.f. 1 April 2017) and also for an immovable property being land or building or both (w.e.f. 1 April 2018). The Act provides for different rates of tax for taxation of capital gains on the basis of the nature or type of capital assets, the holding period thereof and the residential status of the assessee.

Section 45 of the Act provides that any profits or gains arising from transfer of a capital asset effected in the 'previous year' will be chargeable to tax under the head 'capital gains'. Such capital gains will be deemed to be the income in the previous year in which the transfer took place.

In view of the above, it can be understood that capital gains shall be chargeable to income-tax only on satisfaction of the following conditions:

- (i) There should be a 'transfer' as defined under section 2(47) read with section 47 of the Act; and
- (ii) The transfer should be that of a 'capital asset' as defined under section 2(14) of the Act.

Where the above conditions are satisfied, income chargeable to tax shall be computed in accordance with the provisions of sections 45 to 55A of the Act.

New regime for taxation of long-term capital gains arising on transfer of listed equity shares and units of equity-oriented funds or business trusts

Section 10(38) of the Act allowed exemption in respect of the long-term capital gains arising on transfer of capital assets, being equity shares of a company or unit of equity-oriented fund or unit of business trust, provided that the transaction of sale took place on or after 1 October 2004 and the transaction of sale was chargeable to Securities Transaction Tax (STT).

It was noticed by the revenue authorities that the exemption was misused in certain cases for declaring unaccounted income as exempt long-term capital gains by entering into sham transactions. With a view to prevent this abuse, vide the Finance Act 2017, a third proviso was inserted under section 10(38) of the ITA to provide that effective assessment year 2018-19, the aforesaid exemption would not be available if the transaction of acquisition of such equity shares is entered into on or after 1 October 2004, and such acquisition is not chargeable to STT.

However, to protect the exemption in genuine cases (where STT could not have been paid), Notification No. S.O. 1789(E) dated 5 June 2017 notified a list of transfers for which the condition of chargeability to STT on acquisition shall not be applicable.

Further, with effect from assessment year 2019-20, the Finance Act, 2018 has withdrawn the exemption under section 10(38) and introduced a new section 112A to provide that long term capital gains exceeding one Lakh rupees, arising from transfer of a long term capital asset being an equity share in a company or a unit of an equity oriented fund or a unit of a business trust shall be taxed at 10% (without indexation). The concessional tax rate of 10% shall apply if:

- In case of equity shares, STT has been paid on both acquisition and transfer thereof
- In case of unit of an equity-oriented fund or unit of a business trust, STT has been paid

on the transfer thereof

Deduction under Chapter VI-A and rebate under section 87A shall not be available. Further, vide a notification dated 4th February 2018, the CBDT has clarified certain Frequently Asked Questions on the new tax regime for taxation of long term capital gains.

13.3 Capital Gains under the DTAA

Like India, other countries may also tax gains arising on transfer of capital assets. However, challenges arise where the capital asset is situated in one country (say Country A) and the income arising from transfer thereof is earned by an assessee, who is a resident of another country (say Country B).

In such a scenario, tax legislation of both the countries may provide for taxation of the said income. Country A shall seek to tax the aforesaid income since the asset is situated in such country (this is usually referred to as 'source rule') while Country B shall seek to tax the same since the taxpayer earning such income is a resident of such country (residency based rule). Accordingly, the said income may be subject to taxation in both countries. In order to avoid double taxation of the same income, Country A and Country B may enter into an agreement defining the rights to tax, mechanism for provision of credit of taxes and avoid double taxation.

Taxation of capital gains under the DTAA is irrespective of the period of holding (ie short-term gain or long-term gain).

13.4 DTAA between India and other countries

The Government of India has entered into DTAA with various countries to provide relief to taxpayers from double taxation of income. As per the UN Model tax convention and OECD Model tax convention, a country of residence always has

the right to tax. The country of source may be given full/ partial/ no rights to tax. Accordingly, where DTAA give right to both the countries to tax one particular source of income, the effect of double taxation on the same amount of income may be eliminated under the DTAA by allowing taxpayer to claim credit, in his country of residence, of the taxes paid by him in the source country. The Government of India, for the purposes of DTAA negotiations, keeps the UN model as base.

13.5 Meaning of the term capital gains

The term "capital gains" has not been defined in any of the DTAA which India has entered with other countries. The said term has also not been defined in any of the model tax conventions. In such a scenario, one may rely on the definition article of the said conventions to ascertain the meaning of the term "capital gains". Article 3(2), the definition article reads as under (the said article is identically worded in both the model tax conventions):

"As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which

the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.”

Given the above, the meaning assigned under the respective domestic laws may be used to interpret the meaning of the term “capital gains”. Accordingly, with respect to India, the term “capital gains” shall be reckoned as per the relevant provisions of the Act, unless the context otherwise requires.

Even under the Act, the term “capital gains” is used to denote only a head/ source of income and hence has not been defined. The section charging such capital gains, section 45(1) of the Act, reads as under:

“Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections 54, 54B, 54D, 54E, 54EA, 54EB, 54F, 54G and 54H, be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.”

Accordingly, “gains from transfer of a capital asset” may be considered as “capital gains”.

13.6 Concept of Transfer vs Alienation

DTAAs entered into by India usually use the phrase “gains from alienation of (type of asset) will be taxable in (country of residence or source)”. Under the Act, the term used is “transfer of a capital asset”. DTAA’s use the term “alienation” whereas Act uses the term “transfer”.

The term “alienation” has neither been defined under the Act nor under the model conventions. However, as per para 5 of the commentary (2011) on UN MC and para 5 of the Commentary (2014) on OECD Model, illustratively, alienation is said to include the following:

- Sale or exchange of property;
- Partial alienation;
- Expropriation;
- Transfer to a company in exchange for stock;
- Sale of a right;
- Gift;
- Passing of property on death

The term “alienation” has been defined in few DTAAs which India has entered into with different countries. See examples below:

Country	Definition of “alienation”
Mauritius, Zambia	The term "alienation" means the sale, exchange, transfer or relinquishment of the property or the extinguishment of any rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States

However, in case of DTAA's where the term "alienation" is not defined, the term will need to be understood as per the general meaning/ model commentaries and cannot be simply ascribed the meaning of "transfer" as defined under section 2(47) of the Act.

13.7 Article 13 of the UN MC and OECD model

UN MC:

Article 13

CAPITAL GAINS

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.*
2. *Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.*
3. *Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
4. *Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:*
 - (a) *Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.*
 - (b) *For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.*
5. *Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 12-month period preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.*

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident”

13.8 OECD MC:

“ARTICLE 13

CAPITAL GAINS

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.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.”

13.9 Capital Gains under the UN MC and OECD Model

Capital gains may be chargeable in the country from where the said income is arising (source rule) or in the country of residence of the taxpayer (residency based rule). The foregoing discussion in this chapter is based on the UN MC as most of the DTAA's which India has signed with other countries are based on the said model tax convention. Where there is a variance between the UN MC and the OECD Model, the same has been highlighted separately.

13.9.1. Taxation on alienation of immovable properties:

A) Article 13(1) under the UN MC reads as under:

“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”

Applicability

Paraphrasing the above, Article 13(1) applies on satisfaction of the following conditions:

- Capital gains are derived by a "resident" of a Contracting State (say Country A)

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- Such gains are derived from alienation of an immovable property
- The “immovable property” is such as is referred to in Article 6
- The immovable property is situated in the other Contracting State (say Country B)

One may appreciate that on account of use of the word ‘may’, both the countries i.e. the country from which the aforesaid income is sourced and the country of which the taxpayer is a resident thereof, have the right to tax the aforesaid income.

That is to say, gains from alienation of immovable property situated in Country B, earned by a resident of Country A shall be chargeable to tax in accordance with the domestic tax laws of Country B. However, Country A, based on the residence of the taxpayer, shall also have the right to levy taxes on the aforesaid income.

Question arises as to how Article 13(1) leads to avoidance of double taxation? The credit of the taxes paid in the source country may be available in the country of residence. Accordingly, where a resident of Country A earns income from sale of shares in country B, the said person shall be liable to pay taxes in such country (i.e. Country B). However, credit to the extent of taxes paid in country B could be available to the said person in country A. (Refer ensuing chapter on Methods for elimination of double taxation).

Meaning of the term “immovable property”

Given the above, let us now understand the meaning of the term “immovable property”. The term “immovable property” is defined under Article 6 as under:

“The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircrafts shall not be regarded as immovable property”

Based on the above, it may be noted that the definition of the term “immovable property” shall be as per the meaning assigned to it under the domestic laws of the country in which the property is situated. However, the following are specifically included under the ambit of the term “immovable property”:

- property accessory to immovable property;
- livestock and equipment used in agriculture and forestry;
- rights to which the provisions of general law respecting landed property apply;
- usufruct of immovable property;
- rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.

Ships, boats and aircrafts are specifically excluded from the ambit of term “immovable property” (since these assets are covered under subsequent clauses).

B) Article 13(1) under OECD Model:

“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”

The said clause is akin to Article 13(1) of the UN MC.

Conclusion

This Article provides right of taxation to both the countries (i.e. country of residence and country of source). The country of source is the country in which the immovable property is physically located. Elimination of double taxation will be based on the tax credit mechanism of both the countries.

13.9.2 Taxation on alienation of movable properties of a Permanent Establishment (‘PE’):

A) Article 13(2) under UN MC:

“Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State”

Applicability

Paraphrasing the above, Article 13(2) applies on alienation of movable property:

- (a) “forming part of” the business property of a PE which an “enterprise of a Contracting State” (say Country A) has in another state (say Country B); or
- (b) pertaining to a fixed base available to a “resident of a Contracting State” in Country B for the purposes of performing Independent Personal Services

Where the above conditions are satisfied, gains will be taxable in the country in which PE is situated or in the country in which there is a fixed base for performing independent personal services.

Example: Say X Limited, tax resident of Country A, has a PE in Country B. The said PE holds properties in Country C. In a scenario where the movable property of the said PE, situated in Country C is alienated by the PE, gains arising therefrom shall be chargeable to tax in Country B, in which the PE is located.

This clause does not apply in case of immovable property, despite being business property of the PE. Gains on alienation of such immovable property shall be governed by the provisions of Article 13(1). Accordingly, in the above example, where the aforesaid property, situated in

Country C, is immovable property (as defined under Article 6), the gains on alienation of such immovable property shall be taxable in Country C.

It may be interesting to analyse a scenario where an enterprise (say tax resident of Country A), which has a PE in (say) Country B, is alienated. In this connection, attention is invited to the following extracts from the OECD Model commentary:

“25. The paragraph makes clear that its rules apply when movable property of a permanent establishment is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment.”

In the aforesaid scenario, as a consequence of the alienation of the enterprise, the PE situated in Country B shall also stand alienated. Accordingly, Article 13(2) shall be applicable. However, the provisions of Article 13(2) will be applicable only to the extent of gains attributable and arising on account of transfer of business property of such PE and the same shall not extend to gains arising on alienation of the enterprise as a whole.

It may also be noted that the gains arising on transfer of movable business properties of a PE can be taxed as per Article 13(2) even in a situation where PE has ceased to exist at the time of alienation of such movable business properties.

However, gains arising on account of alienation of stock-in-trade, shall not be governed by the above article despite it being movable business property of the PE, since the same has been specifically covered under the ambit of Article 7 dealing with Business Profits.

Meaning of “movable property”

The term ‘moveable property’ has not been defined in the UN/ OECD Model commentaries. In common parlance, it may mean all properties, which are other than immovable properties. The term movable property is not defined under the Act as well. Therefore, the term “movable property” will need to be understood in its general sense, basis the local laws of the country. Typically the term “movable property” will include, oil rigs, intangible property, etc.

B) Article 13(2) under OECD Model:

“Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State”

The said clause is akin to Article 13(2) of the UN MC, except that the aforesaid clause does not refer to provision of independent personnel services from a fixed base. The said reference is absent on account of deletion of Article 14 from OECD Model i.e. Provision of Independent Personnel Services.

Conclusion

This Article provides right of taxation to the country in which the PE is located (country of

source), where there is transfer/ alienation of business property associated with the PE. The country of source gets a non-exclusive right of taxation. This Article will be applicable even in a case where the PE has ceased to exist.

The country of residency will still have the right to tax based on its domestic tax laws. Elimination of double taxation will be under the tax credit mechanism of both the countries.

13.9.3 Taxation on alienation of ships, aircrafts and boats:

A) Article 13(3) under UN MC

“Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated”

Paraphrasing the above, Article 13(3) applies to gains arising from alienation of the following properties:

- Ships or aircrafts operated in international traffic;
- Boats engaged in inland waterways transport;
- Movable property “pertaining” (or connected/ relating/ relatable) to the operation of such ships, aircraft or boats

Under this clause, taxation of gains arising from alienation of aforesaid properties shall be chargeable to tax in the country in which the Place of Effective Management (‘POEM’) of the entity is located. This clause gives exclusive taxation rights to the country where POEM is located.

Concept of POEM

POEM, in summary, means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole, are in substance made.

Under para 10 of the commentaries on Article 4 of the UN MC (2011), POEM has been explained as under:

“It is understood that when establishing the “place of effective management”, circumstances which may, inter alia, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and the place where the most important accounting books are kept”

Under para 10 of the commentaries on Article 4 of the OECD Model (2014), POEM has been explained as under:

“The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in

substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.”

Example: X LLP owns and operates an aircraft plying from Country A to Country B on regular basis. All the key managerial personnel are based out of Country A and hence all the commercial decisions that are necessary for the conduct of the business of X LLP is concluded in Country A. X LLP now proposes to sell the aforesaid aircraft to Y LLP, tax resident of Country B, while it is parked at the airport in Country B. As per the local tax laws of Country B, since the said property (aircraft) is transferred in Country B, the said income is said to be ‘sourced’ and therefore taxable in Country B. In such a situation, assuming that the aforesaid clause [Article (13(3))] exists in the DTAA between Country A and Country B, the country with taxing rights shall be the place where the POEM of X LLP is situated. Accordingly, the aforesaid capital gains shall be chargeable to tax in the hands of X LLP by Country A and not by Country B.

Further, the concept of POEM has been introduced in section 6(3) of the Act and the CBDT has issued Circulars No. 6 of 2017 dated 24th January 2017, 8/2017 dated 23rd February 2017 and 25/2017 dated 23rd October 2017 providing guiding principles for determination of POEM of companies.

B) Article 13(3) under OECD Model

“Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated”

The said clause is akin to Article 13(1) of the UN MC.

Conclusion

This article applies specifically in case of alienation of ships, aircrafts, boats and movable property pertaining to operation of such ships, aircrafts, boats, etc. This article provides exclusive right of taxation to the country in which there is place of effective management. This article is a major variation from the concept of source basis of taxation and residency basis of taxation.

13.9.4 Taxation on alienation of interest in an entity which principally holds immovable property

A) Article 13(4) under UN MC

“Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:

- a) *Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or*

indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities;

- b) *For the purposes of this paragraph, “principally” in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate”*

(emphasis supplied)

Application

Paraphrasing the above, Article 13(4) will apply on satisfaction of the following conditions:

- Alienation should be of shares of capital stock of a company, or of an interest in a partnership, trust or estate (shares etc.);
- The property of such company, partnership, trust or estate consists directly or indirectly “principally” of immovable property situated in a Contracting State (say Country A);
- Such company, partnership, trust or estate does not use the immovable property in its business activities;
- Such company, partnership, trust or estate could be engaged in the business of management of immovable property.

Upon satisfaction of the above conditions, gains arising from alienation of the shares/ interest in partnership/ trust/ estate may be taxed in the country in which the immovable property is located (state of source).

Commentary on UN MC provides the rationale of this para. As per Para 8 of the said commentary, Article 13(4) is “*designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the sale of shares in such a company. This is especially so where ownership of the shares carries the right to occupy the property.*”

On a plain and literal reading of the aforesaid paragraph, following factors may not make a difference in applicability of Article 13(4):

- Nature and type of shares and percentage of holding (alienation of even one share will trigger taxation);
- Alienation of listed/ unlisted shares, interest in partnership, trust or estate;
- Mode of alienation (eg. in the course of a reorganization or family settlement);
- Investor (eg pension fund) is exempt from tax in country of residence on its investment income;
- Irrespective of whether the investee is resident of country from which such income is

sourced or a resident of third country.

Article 13(4) may not be applicable under the following circumstances:

- Where the property which principally consists of immovable properties is used in their business activities (eg, a company which develops, operates and maintains an industrial park) – In such a situation, other relevant article(s) may be applicable;
- The value of immovable property < 50% of aggregate value of total assets held by such company/ partnership/ trust/ estate.
- On alienation of debentures, bonds etc. – since only shares are covered

Relevance of situs of immovable property

It is pertinent to note that it is not necessary for the company/ partnership/ trust/ estate to be situated/ registered in India. The relevant proposition is the existence of immovable property (subject to the threshold) in relevant country to trigger the taxability as per Article 13(4).

Meaning of “directly or indirectly”

It may be imperative to analyse the significance and application of the term “directly or indirectly” in relation to value of immovable property. The expression “indirectly” means “through one or more interposed entities”²²⁶. Where the said term is absent in DTAA, Article 13(4) shall be applicable only to immediate entity in the entire chain of holding rather than to all the entities.

Determination of value of immovable property exceeding 50%

Given the above mechanism and threshold to trigger the aforesaid clause, practical difficulties may arise at the time of application thereof.

For instance, the aforesaid clause does not make it clear as to the date on which the value of the assets has to be seen. One may consider the date of sale of shares, or date of audited latest accounts, or date of purchase of property, or some other date.

Another issue could arise in case of entities having book losses. In such a case a question may arise as to whether the threshold of 50% should be analysed vis-à-vis gross value of assets or should the loss in P&L Account be adjusted against the gross value of assets.

Although Article 13(4) is silent on the ambiguity referred to in the above question, the same has been clarified in para 28.4 of the commentary in the OECD Model. The said para provides that *“the determination of whether shares of a company derive more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property)”*.

Given the above, let us analyse the applicability of the said clause by way of the following

²²⁶ UN Commentary (2011) Para 8

example:

Liabilities	Amount (in Rs)	Assets	Amount (in Rs)
Share Capital	8,000	Land (not used for business activities)	4,000
P&L Account	(3,000)	Machinery	3,000
Loans	5,000	Current Assets	3,000
Total	10,000	Total	10,000

In the instant case, where the threshold of 50% is compared vis-a-vis gross value of assets, land value shall be lesser than 50% (i.e. 40%) while where the loss in P&L Account is adjusted against the gross value of assets, the threshold shall be higher than 50% (i.e. 57%).

Accordingly, the applicability of the said clause shall be analysed as under:

(A) Gross value of assets: Rs. 10,000

(B) Value of immovable property (in the instant case - land): Rs. 4,000

Percentage of value of total assets = 40% [(A)/ (B)]

Accordingly, the aforesaid clause shall not be triggered and other clauses of Article 13, as applicable, shall provide taxing rights to relevant countries/ jurisdictions.

B) Article 13(4) under OECD MC:

“Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State”

The said clause is akin to Article 13(4) of the UN MC, except that the aforesaid clause:

- Does not specifically refer to alienation of interest in a partnership, trust or estate.
- Does not exclude entities which use immovable property for business activities.

Conclusion

This article provides that alienation of shares of a company or interest in partnership/ trust or estate, which consists directly or indirectly principally of immovable property in other states, may be taxable in the country in which the immovable property is situated. However, this article will not apply in case the immovable property is used for the business activities of the company /partnership /trust /estate.

Example 1:

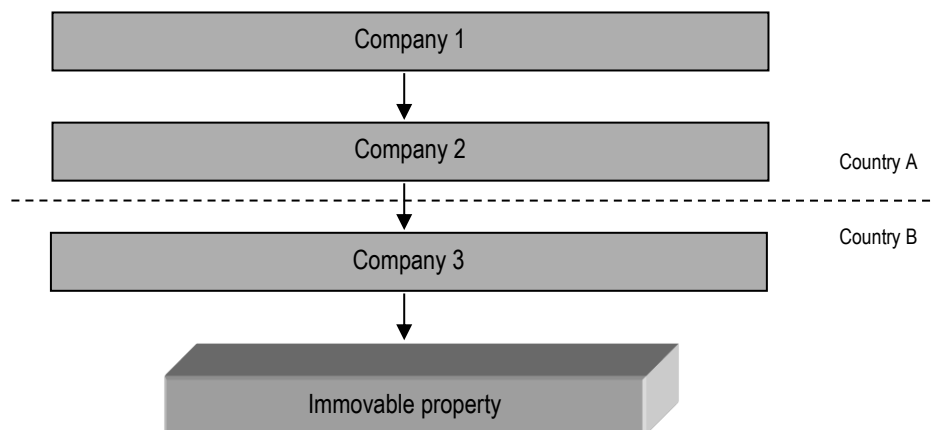
Situation	Under UN MC	Under OECD Model
1) Tax resident of Country A has sold shares of XYZ	Article 13(4) shall be applicable since XYZ Limited	Article 13(4) shall be applicable since XYZ

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Situation	Under UN MC	Under OECD Model
Limited (XYZ Limited derives more than 50% of its value from immovable properties situated in Country B)	derives more than 50% of its value from immovable property situated in Country B. Accordingly, Country B shall have the rights to tax the aforesaid income.	Limited derives more than 50% of its value from immovable property situated in Country B. Accordingly, Country B shall have the rights to tax the aforesaid income.
2) Supplementary to Scenario 1 above, where the aforesaid property is utilized by XYZ Limited for its business activities	Article 13(4) shall not be applicable since XYZ Limited uses the immovable property for its business activities. Accordingly, capital gains arising to a tax resident of Country A shall be chargeable to tax as per other relevant clauses of the Article.	Article 13(4) shall be applicable despite the fact that XYZ Limited uses the immovable property for its business activities. Accordingly, rights to tax the aforesaid income shall continue to vest with Country B.

Example 2:

Consider a scenario where a corporate group has a multi-tier structure as under, where Immovable property is held by Company 1 through Company 2 and Company 3.



In such a case, if Company 1 sells shares of Company 2, then whether the capital gains will be taxable in Country B under Article 13(4) (assuming the only asset held by company 2 is shares of company 3. Also, the only asset held by company 3 is immovable property)?

The language of article 13(4) of UN Model states that if the “property of the company” consists directly or indirectly, principally of immovable property, then Country B can tax the gain. Very strictly, immovable property belongs to Company 3 and not to Company 2. Can one say that indirectly the immovable property is of Company 1?

Also, Article 13(4) of the OECD model as well as Para 3.6.3 of the Commentary to the OECD Model specifically states that Article 13(4) shall be applicable only if more than 50% of the value of the shares is derived **directly or indirectly** from immovable property situated in Country B.

Therefore, what needs to be seen is whether company 2 derives value substantially from the immovable property(ies).

In the instant case, value of company 2 is derived from shares held by it in company 3 which in turn derives its value from the immovable property situated in Country B. That is to say that company 2 derives value indirectly from immovable property situated in Country B. Accordingly, gains in the hands of Company 1 arising on account of alienation of shares in Company 2 shall be taxable in Country B based on source rule under both the model tax conventions discussed above.

13.9.5 Taxation on alienation of shares in a company:

A) Article 13(5) of UN MC:

“Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 12-month period preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company”

Applicability

Paraphrasing the above, Article 13(5) applies on satisfaction of the following conditions:

- Alienation of shares of a company;
- Gains other than those specifically covered by Article 13(4);
- The alienator held at least a specified percentage (as negotiated by the relevant countries while agreeing to the aforesaid clause in the DTAA) in the capital of the investee company;
- Such holding should have been at any time during the 12-month period preceding the aforesaid alienation; and
- The investee company should be a tax resident of the other country.

Where all the aforesaid conditions are satisfied, the right to tax income arising from alienation of the said shares shall be taxable in the country where the investee company is a tax resident i.e. the source state would have the right to tax the aforesaid income arising to taxpayer on alienation of shares.

It may be pertinent to note that the aforesaid clause is restricted in its application to shares and does not extend to other securities such as bonds, debentures etc.

Therefore, say XYZ Limited, a tax resident of Country A, alienating the shares of a company

registered/ incorporated and resident (as per DTAA) of Country B, shall be liable to pay taxes in a given country based on the holding of the alienator in the past 12 months preceding the date of alienation.

Where the aforesaid holding of tax resident of Country A in the investee company is lesser than the pre-determined percentage (as per relevant DTAA), no taxes may be payable by such person in Country B. However, on the contrary, where the said holding exceeds the pre-determined percentage, taxes shall be payable in both the countries (subject to eligibility of tax credit and domestic tax laws of the resident state).

Example:

X Limited, tax resident of Country A bought shares equal to 20% of the equity share capital of Y Limited (tax resident of Country B) on 1 January 2001. The shareholding threshold for substantial holding is prescribed in the DTAA between Country A and Country B is 10%.

Situation 1: X Limited sells shares equal to 11% on 31 January 2001: The said gains shall be taxable in Country B as per Article 13(5) since the shareholding of X Limited in Y Limited exceeds 10% (i.e. shareholding is 20%).

Situation 2: X Limited now sells shares equal to 5% on 1 December 2001: As on 1 December 2001, X Limited holds 9% shares in Y Limited. The gains arising on alienation of said 5% holding shall be taxable in Country B as per Article 13(5) since the shareholding of X Limited in Y Limited in the past 12 months (December 2000 to November 2001) was in excess of DTAA threshold of 10%.

Situation 3: X Limited now sells balance holding of 4% on 31 March 2002: The gains arising on alienation of said 4% holding shall not be covered under the ambit of Article 13(5) since the shareholding of X Limited in Y Limited in the past 12 months (April 2001 to March 2002) had been lesser than DTAA threshold of 10%. Accordingly, taxability under the said scenario shall be as per residuary clause.

B) OECD Model

There is no similar clause in the OECD Model. Accordingly, based on the facts and circumstances of the case, other relevant clauses of Article 13 shall apply.

Conclusion

This article is applicable for gains arising on alienation of shares of a company other than alienation of shares referred to in Article 13(4) [i.e. shares which derive its value directly or indirectly from immovable property]. This article provides that gains arising on alienation of shares of a company by a resident of one country, holding more than the prescribed percentage of shares of a company in another country for a particular time period, will also be taxable in the country in which the company, whose shares are alienated, is resident. This article provides non-exclusive taxation right to the country in which the company, whose shares are to be transferred, is a resident. Where the percentage of shares held or the time period is less than what is prescribed in the DTAA the country in which the company, whose shares are to be

alienated, will not have the right to tax.

13.9.6 Residuary clause

A) Article 13(6) of UN MC:

“Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident”

The aforesaid clause is a residuary clause and accordingly seeks to cover within its ambit gains arising on alienation of all the properties which are otherwise not covered in the aforesaid clauses.

The residuary clause may cover the following:

- Sale of shares in a company [unless covered in Article 13(4)/ (5) above];
- Securities such as bonds, debentures, units, intangibles such as trademark copyright;
- Movable property [unless covered in Article 13(2)], etc.

This clause allows the country of residence of the alienator to tax the income in the nature of capital gains sourced from other countries. Thus all the movable properties, other than those specifically set out in aforesaid clauses, shall be subject to taxes only in the state of residence of the alienator.

B) Article 13(6) of OECD Model:

“Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident”

The said clause is akin to Article 13(6) of the UN MC.

Conclusion

This article is residuary article and seeks to cover all other situations of alienation of property which are not covered under other paras. This article provides exclusive right of taxation to the country of residence.

13.10 Distinctive features of India’s DTAA with other countries

UN model is the base for the Government of India while negotiating a DTAA with other countries. However, there may be deviations from the model convention. DTAA are suitably modified to give effect to the finally agreed terms of negotiations between the countries.

In this section we have analysed some of the prominent DTAA which the Government of India has negotiated with other countries:

13.10.1 India – Netherlands DTAA

Article 13 of the India-Netherlands DTAA reads as under:

“1. Gains derived by a resident of one of the States from the alienation of immovable property referred to in Article 6 and situated in the other State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of one of the States has in the other State or of movable property pertaining to a fixed base available to a resident of one of the States in the other State for the purpose of performing independent personal services, including such gains from the alienation of such permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the State in which the place of effective management of the enterprise is situated. For the purposes of this paragraph, the provisions of paragraph 3 of Article 8A shall apply.

4. Gains derived by a resident of one of the States from the alienation of shares (other than shares quoted on an approved stock exchange) forming part of a substantial interest in the capital stock of a company which is a resident of the other State, the value of which shares is derived principally from immovable property situated in that other State other than property in which the business of the company was carried on, may be taxed in that other State. A substantial interest exists when the resident owns 25 per cent or more of the shares of the capital stock of a company.

5. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 shall be taxable only in the State of which the alienator is a resident.

However, gains from the alienation of shares issued by a company resident in the other State which shares form part of at least a 10 per cent interest in the capital stock of that company, may be taxed in that other State if the alienation takes place to a resident of that other State. However, such gains shall remain taxable only in the State of which the alienator is a resident if such gains are realised in the course of a corporate organisation, reorganization, amalgamation, division or similar transaction, and the buyer or the seller owns at least 10 per cent of the capital of the other.

...”

(emphasis supplied)

In the context of India - Netherlands DTAA, paras 1, 2, 3 and 4 are in line with the UN Model, however para 5 has been worded differently.

Implications under Article 13(5) of the India - Netherlands DTAA have been analysed and explained on the basis of the following example:

X Limited, tax resident of Netherlands, holds equity shares in Y Limited, tax resident of India.

Situation 1: Shares of Y Limited are alienated to a resident of India (say A Limited)

- If shares (which are alienated) forms part of less than 10% interest in the capital stock of Y Limited, gains shall be taxable only in the country of residence of alienator (i.e. Netherlands).
- Conversely, where shares (which are alienated) exceed 10% interest in the capital stock of Y Limited, gains may be taxed in India. However, such gains shall be taxable only in the country of residence of the alienator i.e. Netherlands if the following conditions are satisfied:
 - (i) Gains are realized in the course of corporate organisation, reorganization, amalgamation, division or similar transaction, and
 - (ii) the buyer (i.e. A Limited) or the seller (i.e. X Limited) owns at least 10 per cent of the capital of the other.

Situation 2: Shares of Y Limited are alienated to a resident of country other than India (say B Limited)

Gains are taxable in state of residence of the alienator (i.e Netherlands) irrespective of the fact that shares transferred exceed 10% of capital stock of Y Limited and that the shares being alienated are of company incorporated in India i.e. Y Limited.

13.10.2 India – UK DTAA/ India – USA DTAA

Article 14 of the India – UK DTAA reads as follows (it is not necessary that Article 13 only shall be capital gains article under treaties – the said article may be placed per the negotiations of participating countries):

“1. Except as provided in Article 8 (Air Transport) and 9 (Shipping) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.”

Article 13 of the India-USA DTAA reads as follows:

“Except as provided in Article 8 (Shipping and Air Transport) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.”

As mentioned earlier in this chapter, under the UN MC and OECD Model, the taxing rights in respect of capital gains are distributed between source country and country of residence in accordance with the nature of the asset being alienated.

However, under the India-UK DTAA and India-USA DTAA, there is no such distribution and both the countries are allowed to levy taxes as per local domestic tax laws. Accordingly, where income arising in the hands of UK/ USA resident is in the nature of capital gains and is sourced from India, then the said income shall be taxable in India as per the domestic tax laws of India. In addition to the above, the said income shall also be taxable in UK/ USA based on the rule of residency as per the domestic tax laws of UK/ USA. However tax credit can be claimed as per

the provisions of the relevant article in the DTAA and domestic tax laws of UK/ USA/ India, as the case may be.

13.10.3 India – Mauritius DTAA

Article 13 of the India-Mauritius DTAA reads as under:

“1. Gains from the alienation of immovable property, as defined in paragraph (2) of article 6, may be taxed in the Contracting State in which such property is situated.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in that other State.

3. Notwithstanding the provisions of paragraph (2) of this article, gains from the alienation of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

**[3A. Gains from the alienation of shares acquired on or after 1st April 2017 in a company which is resident of a Contracting State may be taxed in that State.*

3B. However, the tax rate on the gains referred to in paragraph 3A of this Article and arising during the period beginning on 1st April, 2017 and ending on 31st March, 2019 shall not exceed 50% of the tax rate applicable on such gains in the State of residence of the company whose shares are being alienated]

***[4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 3A shall be taxable only in the Contracting State of which the alienator is a resident.]*

5. For the purposes of this article, the term "alienation" means the sale, exchange, transfer, or relinquishment of the property or the extinguishment of any rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States.”

(emphasis supplied)

**Paragraphs 3A, 3B inserted by Notification No. SO 2680(E) {NO.68/2016 (F.No.500/3/2012-FTD-II)} dated 10-8-2016, w.e.f. 1-4-2017 (assessment year 2018-19).*

***Paragraph 4 substituted by Notification No. SO 2680(E) {NO.68/2016 (F.No.500/3/2012-FTD-II)} dated 10-8-2016, w.e.f. 1-4-2017 (assessment year 2018-19).*

In the context of India-Mauritius DTAA, paras 1, 2 and 3 are in line with the UN Model, however para 4 is worded differently.

Implications under Article 13(4) of the India – Mauritius DTAA

- Gains on alienation of property, other than those mentioned in paras 1 to 3, will be taxable in the in the country of residence of the alienator (i.e Mauritius)
- Paras 3A and 3B of the revised DTAA provide for source based taxation of capital gains arising from alienation of shares acquired on or after 1 April 2017 in a company resident in India. Simultaneously, investments made before 1 April 2017 have been grandfathered and will not be subject to capital gains taxation in India. Where such capital gains arise during the transition period from 1 April 2017 to 31 March 2019, the tax rate will be limited to 50% of the domestic tax rate of India. Taxation in India at full domestic rate will take place from financial year 2019-20 onwards.
- The benefit of 50% reduction in tax rate during the transition period from 1 April 2017 to 31 March 2019 shall be subject to the Limitation of Benefits in Article 27A, whereby a resident of Mauritius (including a shell/conduit company) will not be entitled to benefit of 50% reduction in tax rate if it fails the main purpose test and bonafide business test. A resident is deemed to be a shell/conduit company, if its total expenditure is less than Rs 27,00,000(Mauritian Rupees 15,00,000) in the immediately preceding 12 months from the date the gains arise. It will however not be so deemed if it is a listed company.
- There is an exclusive right to Mauritius to tax gains arising in the hands of residents of Mauritius on alienation of all the properties excluding immovable properties, business property of a PE, ships, aircrafts and shares acquired on or after 1 April 2017 of an Indian company. Accordingly, besides these exclusions, gains arising to a tax resident of Mauritius on alienation of any other property will not be taxable in India as the same gets covered by the residuary clause [Article 13(4)].

13.10.4 India – Sweden DTAA

Article 13 of the India-Sweden DTAA reads as follows:

“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.

2. Gains from alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains derived by a resident of a Contracting State from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

With respect to gains derived by the Swedish, Danish and Norwegian air transport consortium Scandinavian Airlines System (SAS), the provisions of this paragraph shall apply only to such portion of the gains as corresponds to the participation held in that consortium by SAS Sverige AB, the Swedish partner of Scandinavian Airlines System (SAS).

4. Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.

5. Gains from the alienation of any property other than that referred to in paragraphs (1), (2), (3) and (4), shall be taxable only in the Contracting State of which the alienator is a resident, provided that such resident is subject to tax thereon in that State. If the resident is not subject to tax thereon, then such gains may be taxed in the other Contracting State.

6. Notwithstanding the provisions of paragraph (5), gains from the alienation of any property derived by an individual who has been a resident of a Contracting State and who has become a resident of the other Contracting State, may be taxed in the first-mentioned State if the alienation of the property occurs at any time during the four years next following the date on which the individual has ceased to be a resident of the first-mentioned State.”

(emphasis supplied)

In the context of India-Sweden DTAA, paras 1, 2, 3 and 4 are in line with the UN Model, however paras 5 and 6 are worded differently.

Implications under Article 13(5) of the India – Sweden DTAA

- Gains on alienation of property, other than those mentioned in paras 1 to 4 (ie other than immovable properties, business property of a PE, ships and aircrafts and shares of a company deriving its value principally from immovable property), will be taxable in the country of residence of the alienator (assuming alienator is a tax resident of Sweden). However, Sweden will have a right to tax only if it levies taxes locally on the gains arising on account of alienation of property.
- Where Sweden does not levy taxes locally on the gains arising on account of alienation of property, India will get the right to taxation. Accordingly, under this para, Sweden does not get an exclusive right of taxation, but conditional right of taxation.
- As against the India-Mauritius DTAA, under the India-Sweden DTAA, whether or not Sweden levies taxes on capital gains locally, is relevant. Where Sweden does not tax locally, India will have the right of taxation of gains arising on alienation.

Provisions similar to Article 13(5) of the India-Sweden DTAA are also present in India–Jordan DTAA and India – Ukraine DTAA.

Implications under Article 13(6) of the India – Sweden DTAA

- Article 13(6) seeks to prohibit taxing rights of country of current residence. However, such prohibition is applicable only where the country of residence has changed during 4 years preceding the alienation of the relevant asset.

Example: Mr. A, a tax resident of India went to Sweden for the first time in January 2010 permanently. Subsequently, on 6th December 2014, he sold shares of an Indian listed company. Assuming Mr. A ceases to be a tax resident of India w.e.f. January 2011, whether the aforesaid alienation of shares shall be taxable in India?

As per the Article 13(6) of India – Sweden DTAA, the aforesaid income shall be taxable in India since Mr. A has been a tax resident of India in the preceding 4 years of date of alienation (the date preceding 4 years from the date of alienation is 7 December 2010 - on such date Mr. A was a tax resident of India)

13.10.5 India – Brazil DTAA

Article 13 of the India-Brazil DTAA reads as follows:

“1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6, which is situated in the other Contracting State, may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in the other State. However, gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

3. Gains from the alienation of any property other than that referred to in paragraphs 1 and 2, may be taxed in both Contracting States.”

(emphasis supplied)

In the context of India-Brazil DTAA, paras 1 and 2 are in line with the UN Model, however para 3 is worded differently.

Implications under Article 13(3) of the India – Brazil DTAA

- As mentioned earlier in this chapter, under the UN MC and OECD Model, the taxing rights in respect of capital gains in the residuary clause is that of the country of residence.
- However, under the India-Brazil DTAA, both the countries are allowed to levy taxes as per domestic tax laws.
- Accordingly, under this article there may be double taxation. However tax credit can be

claimed as per the provisions of the relevant article in the DTAA and domestic tax laws of Brazil/ India, as the case may be.

Provisions similar to Article 13(3) of the India-Brazil DTAA are also present in the India – Canada DTAA.

13.10.6 India – Singapore DTAA

Article 13 of the India-Singapore DTAA reads as follows:

“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.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in the Contracting State of which the alienator is a resident.

**[4A. Gains from the alienation of shares acquired before 1 April 2017 in a company which is a resident of a Contracting State shall be taxable only in the Contracting State in which the alienator is a resident.*

4B. Gains from the alienation of shares acquired on or after 1 April 2017 in a company which is a resident of a Contracting State may be taxed in that State.

4C. However, the gains referred to in paragraph 4B of this Article which arise during the period beginning on 1 April 2017 and ending on 31 March 2019 may be taxed in the State of which the company whose shares are being alienated is a resident at a tax rate that shall not exceed 50% of the tax rate applicable on such gains in that State.

5. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4A and 4B of this Article shall be taxable only in the Contracting State of which the alienator is a resident.]

Paragraph 4 omitted by Notification No. SO 935(E) [No.18/2017 (500/139/2002-FTD-II), dated 23-3-2017, w.e.f. 1-4-2017

*Paragraphs 4A, 4B, 4C and 5 inserted by Notification No. SO 935(E) [No.18/2017 (500/139/2002-FTD-II), dated 23-3-2017, w.e.f. 1-4-2017

(emphasis supplied)

In the context of the India-Singapore DTAA, the article is largely in line with the UN model giving right of taxation to the country in which the alienator is the resident. However, under India-Singapore DTAA, the benefit of DTAA will be limited upon satisfaction of the conditions of the DTAA (popularly known as the “Limitation of Benefit” clause) (“LOB clause”).

The revised LOB clause in Article 24A of the India – Singapore DTAA provides as under:

ARTICLE 24A

1. A resident of a Contracting State shall not be entitled to the benefits of paragraph 4A or paragraph 4C of Article 13 of this Agreement if its affairs were arranged with the primary purpose to take advantage of the benefits in the said paragraph 4A or paragraph 4C of Article 13 of this Agreement, as the case may be.
2. A shell or conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of paragraph 4A or paragraph 4C of Article 13 of this Agreement. A shell or conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State.
3. A resident of a Contracting State is deemed to be a shell or conduit company if its annual expenditure on operations in that Contracting State is less than S\$ 200,000 in Singapore or Indian Rs. 5,000,000 in India, as the case may be:
 - (a) in the case of paragraph 4A of Article 13 of this Agreement, for each of the 12 month periods in the immediately preceding period of 24 months from the date on which the gains arise;
 - (b) in the case of paragraph 4C of Article 13 of this Agreement, for the immediately preceding period of 12 months from the date on which the gains arise.
4. A resident of a Contracting State is deemed not to be a shell or conduit company if:
 - (a) it is listed on a recognised stock exchange of the Contracting State; or
 - (b) its annual expenditure on operations in that Contracting State is equal to or more than S\$ 200,000 in Singapore or Indian Rs. 5,000,000 in India, as the case may be:
 - (i) in the case of paragraph 4A of Article 13 of this Agreement, for each of the 12-month periods in the immediately preceding period of 24 months from the date on which the gains arise;
 - (ii) in the case of paragraph 4C of Article 13 of this Agreement, for the immediately preceding period of 12 months from the date on which the gains arise.
5. For the purpose of paragraph 4(a) of this Article, a recognised stock exchange means:
 - (a) in the case of Singapore, the securities market operated by the Singapore Exchange Limited, Singapore Exchange Securities Trading Limited and The Central Depository (Pte) Limited; and

- (b) in the case of India, a stock exchange recognised by the Securities and Exchange Board of India.

Explanation: The cases of legal entities not having bona fide business activities shall be covered by paragraph 1 of this Article.

The conditions of LOB clause are summarised as under:

- The benefit of residence based taxation for investments made before 1 April 2017 and the 50% reduction in tax rate for investments made during the transition period from 1 April 2017 to 31 March 2019, shall be subject to satisfaction of main purpose test and bonafide business test.
- A resident would be deemed to be a shell/conduit company if its total expenditure on operations in the Contracting State is less than Rs.50,00,000 (Singapore Dollars 2,00,000)
 - (i) for each of the 12 months period in the immediately preceding 24 months from the date the gains arise, in the case of benefit of residence based taxation for investments made before 1 April 2017
 - (ii) for the immediately preceding 12 months from the date the gains arise, in the case of benefit of 50% reduction in tax rate for investments made during the transition period from 1 April 2017 to 31 March 2019
- A resident is not deemed as a shell or conduit company if it is a listed company or its annual expenditure on operations is more than the specified amounts

Judicial precedent

In AAR Rulings, in the case of BG Asia Pacific Holding (Pte.) Ltd., [2021] 125 taxmann.com 2 (AAR - New Delhi), it was held that where applicant, a company incorporated in Singapore, sold shares held by it in an Indian company whose shares were listed on recognized stock exchange in India, to a buyer company incorporated in India, capital gain arose on such sale of shares is liable to be taxed in Singapore in view of article 13(4) of India-Singapore DTAA and not in India. It was noted that after introduction of provision of Article 13(4) of India-Singapore DTAA with effect from 1-8-2005, capital gain derived by resident arising on sale of shares is made taxable in state of residence of person. Since applicant is resident of Singapore, capital gains arising to it on sale of shares of GGCL will be liable to tax in Singapore only in accordance with provisions of article 13(4) of India-Singapore DTAA and not in India.

However the as per the revised India Singapore DTAA, capital gains on sale of shares acquired on or after 01.04.2017 may be taxable in India.

The text of IN-SG is as follows:

4. 1[***]

2[4A. Gains from the alienation of shares acquired before 1 April 2017 in a company which is a resident of a Contracting State shall be taxable only in the Contracting State in which the alienator is a resident.

4B. Gains from the alienation of shares acquired on or after 1 April 2017 in a company which is a resident of a Contracting State may be taxed in that State.

4C. However, the gains referred to in paragraph 4B of this Article which arise during the period beginning on 1 April 2017 and ending on 31 March 2019 may be taxed in the State of which the company whose shares are being alienated is a resident at a tax rate that shall not exceed 50% of the tax rate applicable on such gains in that State.

5. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4A and 4B of this Article shall be taxable only in the Contracting State of which the alienator is a resident.]

1. Paragraph 4 omitted by Notification No. SO 935(E) [No.18/2017 (500/139/2002-FTD-II), dated 23-3-2017, w.e.f. 1-4-2017. Prior to its omission, said paragraph, as amended by Notification No. So 1022(E), dated 18-7-2005, read as under :

"4. Gains derived by resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs 1, 2 and 3 of this Article shall be taxable only in that State."

2. Paragraphs 4A, 4B, 4C and 5 inserted by Notification No. SO 935(E) [No.18/2017 (500/139/2002-FTD-II), dated 23-3-2017, w.e.f. 1-4-2017.

13.10.7 India – Cyprus DTAA

Like the Mauritius and the Singapore DTAA, the DTAA with Cyprus was also renegotiated vide notification no. so 64(e) [no.3/2017 (f.no.504/05/2003-ftd-i)], dated 10 January 2017, inter alia to replace residence based taxation of capital gains with source based taxation. Grandfathering has been allowed of investments undertaken prior to 1 April 2017.

13.10.8 India – Hong Kong DTAA

The recently signed India – Hong Kong DTAA mainly provides for source based taxation of capital gains. Even the residuary para provides for taxability as per domestic law of each Contracting State. The DTAA also contains an anti-abuse provision that the benefits of the Capital Gains Article shall not be available if the main purpose or one of the main purposes of any person concerned with the alienation of property in respect of which the capital gains are derived is to take advantage of the Article by means of that alienation.

13.11 Taxation of indirect transfers

13.11.1 Meaning of indirect transfer

Indirect transfer, put simply, is a transfer in which, one party is transferring underlying capital asset or property or object to another party through an intermediary.

With the liberalization of the Indian economy since the 1990s, substantial capital inflow has

taken place into India. Often, these investments are made through intermediary (ies), set-up in a favourable (no or low tax) jurisdiction. When the investor wants to exit from Indian business, generally the two alternatives considered are (i) either to sell shares in the Indian company to a new investor, or (ii) to sell shares in the holding company to the new investor. In both situations, capital gains may arise to the investor on account of accretion in value of the aforesaid Indian business. In the first case, the transaction involves transfer of assets located in India i.e. shares of the Indian company. This is called direct transfer of shares. In the second case, the transaction occurs outside India through a foreign company. This is called indirect transfer of shares/ assets of the Indian company.

13.11.2 Indirect transfer and tax arbitrage

Example: X Company, tax resident of Country X (X Co), has set up an intermediary holding company in Country Y (low tax jurisdiction), (Y Co). Y Co, has further set up an operative subsidiary in India (Ind Co). The Ind Co carries out operations in India and has derived substantial value in the Indian markets. X Co now wishes to exit the Indian markets and is seeking a buyer. Another Company, tax resident of Country Z (Z Co), is keen to acquire the shares of Ind Co.

The management of X Co decides that Y Co will sell the stake in Ind Co to Z Co. Accordingly, the said transfer, being a direct transfer of shares of Ind Co, shall be chargeable to tax in India under the Act. However, where India – Country Y DTAA provides that the capital gains accruing on account of alienation of shares of a company resident of another state (Ind Co), shall be taxable only in the country of residence of the alienator (Y Co), the transaction of sale of shares of Ind Co shall not be taxable in India. (eg India – Mauritius DTAA)

However, where the management of X Co decides that it will sell shares of Y Co to Z Co (thus effectively transferring Ind Co to Z Co), the said transaction shall be an indirect transfer of shares of an Indian company. In the instant case, shares of Y Co (non-resident) have been transferred by X Co (another non-resident) outside India. Accordingly, since no transfer has taken place in India, it may have been possible to contend that share sale is not taxable in India. (refer subsequent discussions)

The above arrangements by non-resident investors were being questioned by the Indian tax authorities and the taxability of indirect transfer reached Supreme Court in the case of Vodafone International Holdings B.V. vs UOI [(2012) 241 ITR 1 (SC)].

13.11.3 Landmark Judgement of Supreme Court in case of Vodafone:

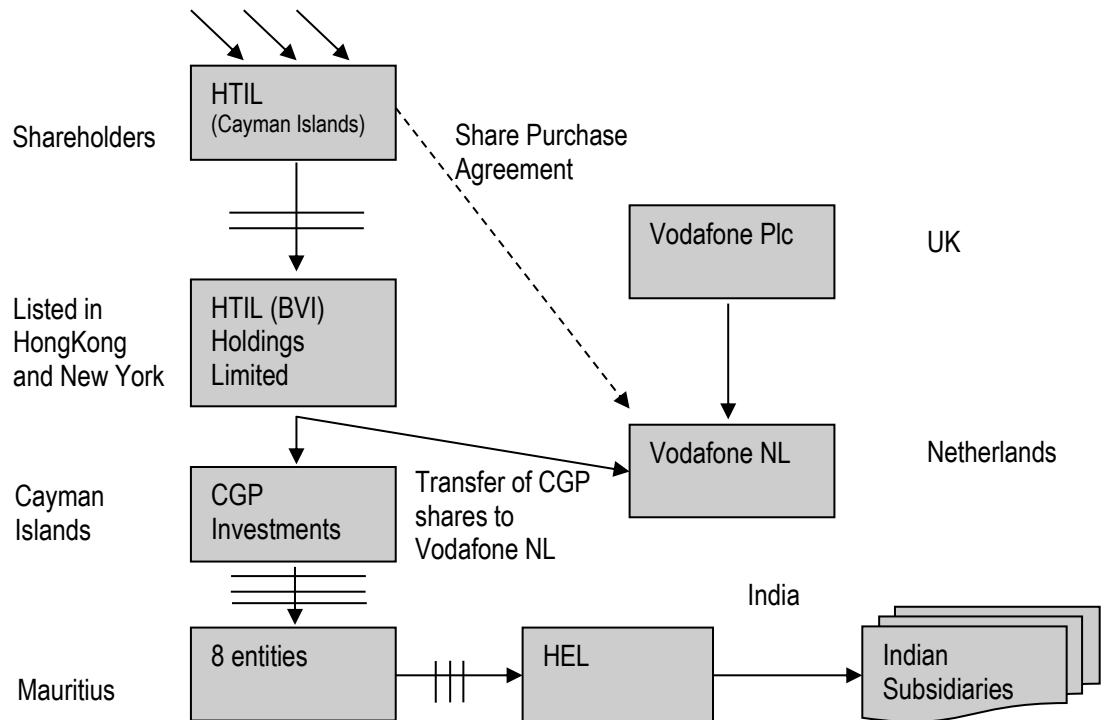
Facts of the case:

In 1992, the Hong Kong based, Hutchison Group indirectly acquired interest in an Indian telecom business through a joint venture ('JV') company viz. Hutchison Telecommunications International (Cayman) Holdings Ltd. (HTIL). HTIL held shares of CGP Investments (Holdings) Ltd. (CGP Investments), a holding company, based in Cayman Island. Through CGP Investments and various Mauritius entities, HTIL held 67% in the Hutch Essar Ltd. (HEL) an Indian JV company. Thus, through CGP Investments, the Hutch Group, held, directly and

indirectly, controlling interest in HEL.

In December 2006, HTIL issued a press statement, stating that it had been approached by various potentially interested parties regarding a possible sale of its equity interests in HEL, which were carrying on telecom operations in India. Vodafone NL, a Dutch entity, made a bid to acquire share capital of CGP Investments and, consequently, in February 2007, entered into an agreement for acquisition of the Indian interests of HTIL. Subsequently, an agreement for Sale and Purchase of Share and Loans (SPA) was entered into between HTIL and Vodafone NL under which HTIL agreed to procure and transfer the entire issued share capital of CGP Investments, held by a group company incorporated in the British Virgin Island, free from all encumbrances together with all rights attaching or accruing, and together with assignment of loan interests. Thereafter, HTIL announced that Vodafone NL had acquired the 'controlling interest' in HEL.

For better understanding of the transaction flow, chart is given here:



Vodafone NL informed Essar Group (the other stake-holder in HEL) about the acquisition of the entire holding from HTIL. Thereafter, Vodafone NL also applied to the Foreign Investment Promotion Board (FIPB) (Indian foreign investment regulatory authority) and sought approval for direct acquisition of 52% in HEL.

- However, it was aptly clarified before the FIPB that as the transaction was offshore,

between two non-residents, the approval was merely taken for 'noting' purposes and was not mandatory.

- Subsequently, FIPB accorded approval and, accordingly, Vodafone NL made the payment of consideration to HTIL for acquiring the entire share capital of CGP Investments, as per the instructions of the Hutch Group.
- HTIL/ Vodafone took a position that since offshore share sale transactions are not taxable in India, no taxes are required to be withheld at source.

In connection with the transaction, the Indian Tax Authorities issued a notice to Vodafone NL enquiring as to why Vodafone NL should not be treated as a 'taxpayer-in-default' for not withholding taxes on its payments to HTIL. Subsequently, Vodafone NL filed a writ petition before the HC, challenging the validity of the notice. The HC, while dismissing the petition filed, held that the said transaction would be subject to the scrutiny of the Indian Tax department for the reason that the dominant purpose of the transaction was to acquire the 'controlling interest' in HEL and, accordingly, the notice issued, prima facie, could not be termed 'erroneous'. Further, as the HC was not in possession of the relevant agreements, it was unable to decide the true nature of the transaction and concluded that it was not in a position to deliberate on the taxability of the transaction, including the jurisdictional issue. Pursuant to the order of the HC, Vodafone NL filed a special leave petition (SLP) before the SC. The SC, however, dismissed the SLP and held that the jurisdictional issue would have to be examined by the Tax department as a preliminary issue.

Pursuant to the observation of the Supreme Court, the Indian Tax Authorities asserted that they had jurisdiction to tax the transaction and considering the fact that Vodafone NL had failed to withhold tax under the provisions of the ITL, it was treated as a 'taxpayer-in-default'. Aggrieved, Vodafone NL challenged this order before the HC by way of a writ petition. While dismissing the petition, the HC held that the tax authority had jurisdiction to tax the transaction.

Aggrieved, Vodafone NL approached the SC on the issue of taxability of the transaction.

Supreme Court's Judgment

Supreme Court in this landmark ruling, held that the indirect transfer would not be taxable in India. Further, Supreme Court accepted that the tax planning, within the framework of law, is permissible, unless planning is sham or through colorable device.

The Supreme Court has held that, one has to look at the "legal effect" only. In the present case, the transfer was taking place between two non-residents, of such asset, which is situated outside India.

The Supreme Court held that one has to "look at" the contract and not "look through" the contract. The source rule provisions under the Indian Tax Laws need to be interpreted and, accordingly, in absence of a 'look through' provision, an indirect transfer will not be taxable in India. The source rule in Indian Tax Law, with respect to a capital asset, requires that the asset which is being transferred be situated in India. If the term 'indirect' is also read into the provision,

it would render the above requirement nugatory. The words 'directly or indirectly' in the source rules would go only with the term 'income' and not with the term 'transfer' of capital assets. Accordingly, indirect transfers are not liable to tax in India under the Act and accordingly, Vodafone was not required to withhold any taxes.

13.11.4 Retrospective amendments by Finance Act, 2012

The ruling of the Supreme Court in the case of Vodafone was overturned by an amendment to the Income-tax Act, 1961 with retrospective effect. Finance Act, 2012 has amended the provision of Section 9 of the Act which relates to Income deemed to accrue or arise in India. The amendments are as under:

In section 9 of the Income-tax Act, in sub-section (1),—

“Explanation 4.—For the removal of doubts, it is hereby clarified that the expression “through” shall mean and include and shall be deemed to have always meant and included “by means of”, “in consequence of” or “by reason of”.

Explanation 5.—For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.”

These explanations have been inserted to clarify that a share or interest in a foreign company or entity shall be deemed to be situated in India, if substantial value of the share or interest is derived, directly or indirectly, from assets located in India.

Thus, if one sells the shares of a foreign company whose “substantial value” is derived on account of Indian investment, such offshore sale will be subject to Indian capital gains tax.

The effect of the amendment is that transfer of shares of a company outside India, deriving substantial value from assets located in India, will be deemed to be an asset located in India and therefore capital gains arising on the sale of the shares will be taxable in India, as income has deemed to accrue or arise in India. The amendment was made with retrospective effect from the date in which the Act had come into force, ie. 1 April 1962.

However even post amendment, there was no certainty in the meaning of the term “substantial value” and the manner of computation of the capital gains arising on account of indirect transfer.

13.11.5 Amendments by the Finance Act, 2015

The Act does not define the expression “share or interest derives its value substantially from assets located in India”. Having regard to the concern expressed by various stake holders an expert committee was set up to look into this aspect. Post the recommendations of the committee certain amendments were made by the Finance Act, 2015. The amendments are summarised as under:

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- Indirect transfer provisions will apply only if, as on “specified date”, the following conditions are satisfied cumulatively -
 - Value of assets located in India > INR 10 Cr; and
 - Value of assets located in India is at least 50% of the value of all assets owned by the company which is subject of transfer. The Delhi High had earlier approved of a similar shareholding being considered as substantial interest in *DIT (IT) v. Copal Research Ltd.* [2014] 371 ITR 114 .
- Value of assets shall be the Fair Market Value (FMV) as on the specified date without reduction of any liabilities.
- Specified date for FMV valuation is generally - the end of the “accounting period” of the foreign company preceding the date of transfer. But it is date of transfer if the book value of assets of foreign company as on date of transfer exceeds the book value at preceding year end by 15%
- Method for determining FMV of assets shall be prescribed by way of separate rules.

Further, vide circular No. 41/2016 dated 21 December 2016, the CBDT issued clarifications on applicability of indirect transfer provisions to Offshore funds and Foreign Portfolio Investors (FPI). However, pursuant to the concerns raised by stakeholders on the possible multiple taxation of same income, the said circular has been kept in abeyance vide Press Release dated 17 January 2017.

13.11.6 Amendments by the Finance Act, 2017

With a view to address the issues raised by the FPI in relation to Circular No. 41/2016, the Finance Act, 2017 amended section 9(1)(i) so as to provide that Explanation 5 shall not apply to any asset or capital asset mentioned therein being investment held by non-resident, directly or indirectly in a Foreign Institutional Investor as referred to in Clause (a) of Explanation 115 AD and registered as Category-I or Category-II Foreign Portfolio Investor under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 made under the Securities and Exchange Board of India Act 1992, as these entities are regulated and broad based. The amendment is effective retrospectively from 1 April 2012 and applicable to assessment year 2012-13 and onwards.

13.11.7 Subsequent developments

Vide Circular No. 28/2017 dated 7 November 2017, the CBDT clarified that the indirect transfer provisions shall not apply where interest or share held indirectly by a non-resident in specified funds, is redeemed in an upstream entity outside India and the redemption is consequent to transfer of shares or securities held in India by the specified funds.

The Delhi ITAT in the case of Cairn UK Holdings (2017) 79 taxmann.com 128 (Del ITAT) upheld taxability of capital gains arising on indirect transfer by rejecting the assessee's argument that the transfer is a mere re-organisation of assets within the group and that there is no “real income”. It further held that the retrospective amendment to section 9 by the Finance Act 2012

cannot be ignored and where the DTAA provides that the income shall be chargeable to tax in accordance with the provision of the domestic law, the said domestic law has to be the amended law.

The AAR ruled in GEA Refrigeration Technologies GmbH (2018) 89 taxmann.com 220 (AAR) that where the applicant German company acquired another unrelated German company and said company derived its value substantially from its group companies situated in different countries whereas its value of assets in a 100% Indian subsidiary was a mere 5.40%, i.e. far lower than the requirement of 50% as provided in Explanation 6 to section 9(1)(i), it failed the test of deriving value substantially from Indian company; thus, income derived by shareholders of seller company from sale of its shares including 100% Indian subsidiary, to applicant German company was not taxable in India.

13.11.8 Indirect transfer and interplay of DTAAs

Indirect transfers are taxable as per the Act, however in terms of section 90, the assessee still has the option to determine his taxability under the Act or under DTAA, whichever is more favourable to him.

Andhra Pradesh High court in the case of Merieux Alliance, France (MA) and Groupe Industriel Marcel Dassault (GIMD) has in principle ruled that (i) in case on account of DTAA the right of taxation of capital gains on indirect transfer is to the country of residence, it will not be taxable in India and (ii) retrospective amendments to the Income-tax Act, 1961 would not impact the allocation of taxing rights under a DTAA.

In the foregoing section we have discussed the impact of DTAAs on taxation of indirect transfer.

Scenario 1: India may have right to tax direct transfer but does not have right to tax indirect transfer under the DTAA

Consider, Article 13 of the India-Germany DTAA

“4. Gains from the alienation of shares in a company which is a resident of a Contracting State may be taxed in that State.

5. Gains from the alienation of any property other than that referred to in paragraphs 1 to 4 shall be taxable only in the Contracting State of which the alienator is a resident.”

In this case, gains on account of indirect transfer may not get covered under para 4 of the India-Germany DTAA since the shares being alienated shall be of state other than India.

Accordingly, in the absence of reference to the domestic tax laws, indirect transfer may not be taxable in India. However, if one considers applicability of Article 13(5) on indirect transfer of shares of Indian company, even then the income shall be chargeable to tax only in the state of residence of the alienator (i.e. Germany).

DTAAs with Switzerland, UAE, Luxembourg, Russia, Syria, Hungary, Ireland, Portugal, Poland, Belgium, France, Denmark, Spain have similar language in the capital gains article.

Scenario 2: India may have right to tax indirect transfer under the DTAA

Consider, Article 14 of the India-UK DTAA

“1. Except as provided in Article 8 (Air Transport) and 9 (Shipping) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.”

In this case, gains on account of indirect transfer will be taxable in India as per the provisions of the domestic laws of both the countries. Therefore, India will have the right to tax gains arising on account of indirect transfer.

DTAA's with US, Brazil, Australia, and Canada, have similar language in the capital gains article.

13.11.9 Miscellaneous considerations

Having understood the relevant provisions of Article 13; Capital Gains and distinctive features of DTAA's entered into by the Government of India, we now proceed to discuss illustrative miscellaneous considerations which may arise during practical application of the aforesaid provisions:

a. No capital gains article in the DTAA

As aforesaid, countries may suitably tailor the UN MC/ OECD Model articles to include the negotiated terms.

There could be a scenario wherein the participating countries negotiate not to include capital gains article under the DTAA.

In such a case, one may argue that treatment of capital gains in the absence of capital gains article in the DTAA should be as if no DTAA had existed.

However, all the articles in the DTAA should be read together. Accordingly, where the capital gains article is absent in the DTAA, one should consider the residuary article i.e. Article 21: Other income. The right to tax income under this article would be different under each treaty based on the negotiated terms between two countries.

To, illustrate, the capital gains article was absent in the India-Malaysia DTAA entered into in the year 2001. However, in the year 2012, the India-Malaysia DTAA was re-negotiated and now has the capital gains article.

b. No capital gains article as well as other income article in the DTAA

There is only one such DTAA with Libya which India has entered into which is devoid of both capital gains and other income article.

This would mean that the participating countries have not entered into any arrangement to absolve taxpayers from double taxation of income in the nature of capital gains and other income. Accordingly, both the countries viz. India and Libya may tax capital gains and other income arising to the taxpayers as per their domestic laws.

Even in the context of taxation of indirect transfer, both the countries may have the right

to tax.

c. Treaty shopping – The use of tax havens

As per para 47 of the commentaries on UN MC (2011), “Treaty shopping” is a form of improper use of tax treaties that refers to arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to indirectly access these benefits.

For example, a taxpayer of Country X, who otherwise would be taxable in source country (say Country Y), would invest in its operations in Country Y through/ via a third country (say Country Z) which has a favourable DTAA with Country Y, leading to an overall reduction in tax outflow to the taxpayer.

In the context of India, historically foreign investors have preferred to invest in India through an incorporated company in low tax jurisdictions to avail the DTAA benefits. The contention of the Income tax department has, *inter-alia*, been that granting DTAA benefits in these circumstances proved to be detrimental to the interests of the income-tax department as the benefits of the DTAA were extended to persons who were not intended to obtain such benefits. Accordingly, use of low tax jurisdictions has been on the radar of the Income tax department.

These show-cause notices created an uproar amongst the foreign investors which lead to the Finance Minister issuing a press notice dated 4 April 2000 to the effect that the view taken by some of the income tax officers pertained to specific cases of assessment and did not represent or reflect the policy of Government of India with regard to the denial of DTAA benefits to the foreign investors. Thereafter, to further clarify the situation, the CBDT issued circular No 789 dated 13 April 2000 to clarify that certificate of residency/ tax residency certificate (TRC) issued by the Mauritian Authorities, will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for the India – Mauritius DTAA. Extracts of the circular are reproduced as below:

“734. Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC)

1. The provisions of the Indo-Mauritius DTAC of 1983 apply to ‘residents’ of both India and Mauritius. Article 4 of the DTAC defines a resident of one State to mean “any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.” Foreign Institutional Investors and other investment funds, etc., which are operating from Mauritius are invariably incorporated in that country. These entities are ‘liable to tax’ under the Mauritius Tax law and are, therefore, to be considered as residents of Mauritius in accordance with the DTAC.

2. Prior to 1-6-1997, dividends distributed by domestic companies were taxable in the hands of the shareholder and tax was deductible at source under the Income-tax Act, 1961. Under the DTAC, tax was deductible at source on the gross dividend

paid out at the rate of 5% or 15% depending upon the extent of shareholding of the Mauritius resident. Under the Income-tax Act, 1961, tax was deductible at source at the rates specified under section 115A, etc. Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.

3. The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, FII's, etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13."

Circular No. 789, dated 13-4-2000

The Supreme Court has upheld the validity of the Circular in the case of Azadi Bachao Andolan [(2003) 263 ITR 706 (SC)]. Further, the Supreme Court after considering the ruling of McDowell & Co Limited vs CTO [(1985) 154 ITR 148 (SC)] held that every attempt of legitimate tax planning or every transaction or arrangement which is perfectly permissible under law and which has the effect of reducing the tax burden of the assessee, must not be looked upon with disfavour. Tax planning may be legitimate provided it is within the framework of the law.

The controversy of the legitimate tax planning re-ignited in 2012 at the time of Supreme Court ruling in the case of Vodafone [(2012) 341 ITR 1 (SC)] (supra). The Supreme Court again reiterated that it cannot be said that all tax planning is illegal/illegitimate/impermissible, where it is within the framework of the law.

The judiciary seems to be in favour of legitimate tax planning, however if the purpose and intent of the planning/ arrangement is merely avoidance of tax, then the courts may lift the corporate veil and tax aggressive tax planning.

As one of the measures to check these issues, the Indian Government renegotiated its tax treaties with Mauritius, Cyprus and Singapore inter alia to introduce source based taxation of capital gains.

It will be interesting to see how some of these issues would be dealt with under the GAAR regime that took effect from 1 April 2017 (previous year 2017-18).

13.11.10 Some recent rulings

AB Holdings (2018) 90 taxmann.com 177 (AAR)

The AAR held that capital gains arising on proposed sale of shares in Indian entity by the applicant, a Mauritian entity, are not chargeable to tax in India under Article 13 of India-Mauritius treaty, however the transaction will have to be benchmarked as per the transfer pricing provisions. It rejected the Revenue's stand that since 'C' Group USA was the ultimate holding company of applicant and Mr. 'S' [Managing Director of 'C' group] was a director in majority of

the group companies including the applicant, the control and management of the applicant was in US and not in Mauritius. The AAR noted that the applicant was holding a valid Tax Residency Certificate (TRC) from Mauritian authority, next it relied on Sanofi Pasteur ruling to hold that setting up a subsidiary for purposes of investment cannot be questioned; Further, AAR acknowledged that being in investment business, it is only logical that Mr. S would have a persuasive influence on the investment decisions of the company, irrespective of where he was located, thus Mr. 'S' and the other Directors' movements in and out of Mauritius at different times, alone cannot lead to the conclusion that the control and management of the company was not in Mauritius, or that it was with the holding company. Further the AAR took note of several trips made by Mr. S to India and Mauritius during investment period, and observed that with immense technological advancement, it is unrealistic to expect all Directors, who are also Directors in many other companies, to be physically present in each and every meeting, and communication is validly done through electronic audio and video devices. Regarding the office / place of management, AAR referred to certification by Mauritian tax authorities about the place of business of Applicant being in Mauritius, address mentioned in returns filed and address where the Board meetings of applicant took place. It also recognized that being an investment company, the applicant does not require huge staff or office. It thus accepted the applicant's plea that it was not benami, or set up for tax avoidance as a colourable device and only for treaty shopping, which in any case is not taboo.

AB Mauritius (2018) 90 taxmann.com 182 (AAR)

The AAR denied India-Mauritius treaty benefit to the applicant. It held the capital gains on sale of shares in Indian entity to another subsidiary as taxable in India; Perusing minutes of Board of directors meeting and share purchase agreement (SPA), AAR observed that Board of directors of applicant merely reiterated the decision of holding company and applicant had no role in decision making process for acquiring shares of the Indian entity from US sellers. It noted that SPA was signed by MD of C Group (comprising two US companies) and not by any director of applicant even though applicant was mentioned as buyer in SPA. Noting that SPA had no clause indicating liability of applicant, AAR remarked that the applicant's name was only superimposed in the Agreement as part of some arrangement, of which the Applicant was not aware at all. Further referring to the minutes of Board meeting held one full year after acquisition of shares, the AAR observed that in this meeting, for the first time, the directors were informed about the reorganization in the group and the decisions about the investment made in the Indian entity was directed to be ratified. Further, notes that US holding company had forgone loan of USD 384,000 for acquiring 1% shareholding and the Applicant had acquired 99% shares without any consideration; Thus, holds two C Group Companies (which paid consideration by cancelling debt of USD 384,000 owed by the US sellers of shares) to be owner of shares, treats applicant as benami or name lender for C Group Companies. The AAR remarked that in a case where the parent acts on behalf of its subsidiary and takes all its decisions, corporate veil between the company's subsidiary and its parent stands torn by the conduct of the group itself. It observed that merely superimposing applicant in transaction done by C Group would render the transaction as colourable device and would fall in category of exception being a mere name

lender. It also observed that TRC gives a presumptive evidence of beneficial ownership and not conclusive presumption. It thus held that the shares belonged to two C group Companies based in USA and accordingly, capital gains are taxable in India as per India - US treaty.

Vanenburg Facilities BV (2017) 397 ITR 425 (AP HC)

The Andhra Pradesh High Court held that capital gains arising to the assessee (a Dutch company) on sale of shares of its Indian subsidiary (holding investment in IT park) to Singapore buyer, was not taxable in India under the India-Netherlands DTAA. It noted that the Assessing Officer erred in applying Article 13(1) of the DTAA by equating alienation of a company's shares to alienation of its immovable property based on the logic that shares partake the character of immovable property. The Court cited legal distinction between 'share sale' and 'asset sale' and approved the ITAT's findings that alienation of shares by assessee does not fall under Article 13(1) of the DTAA and by virtue of residuary clause in Article 13(5), gains will be exempt from taxation in India.

14. Article 14 – Independent Personal Services

Article 14 of the UN Model Convention (the Article / Article 14) deals with Independent Personal Services (IPS). The OECD Model Convention has deleted Article 14 on IPS (on 29 April 2000) and the provisions of this Article have been clubbed with the provisions of Article 7 (i.e. Business profits) on a rationale that the distinction between business and profession has become thin and the commercial atmosphere of the modern times has taken away the distinction between the two to a great extent. However, in almost all the treaties India has entered into with the other countries, Article 14 is very much in existence.

14.1 Article 14 as per UN Model Convention

Article 14 reads as under:

“1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

- (a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or*
- (b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.*

2. The term “professional services” includes especially independent scientific, literary,

artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.”

Article 14 in UN Model is similar to the provisions in the erstwhile OECD Model. The only distinction being, the OECD Model, did not contain paragraph 1(b), as the UN Model as stated above. The provisions of this Article under the different Model Conventions are contained in Annexure A hereto. Also, a comparative chart for Article 14 having regard to the various DTAA's entered into by India with other jurisdictions is tabulated in Annexure B for ready reference.

Paraphrasing Article 14, the right to tax the income under this Article mainly lies with the country of residence of the taxpayer (residence rule). However, the Article provides that Income can also be taxed in the country from where such income is sourced (source rule) if the following conditions are satisfied:

- Such income is in respect of professional services or other activities of an independent character.
- The person has either:
 - A fixed base regularly available to him in the country of source for “performing his activities”; or
 - His aggregate stay in the country of source amounts to or exceeds 183 days in any period of 12 months commencing or ending in the relevant fiscal year.

14.2 The Article at a glance

- The Article covers independent activities involving professional skills.
- It normally covers services rendered by individuals. However, in case of Double Tax Avoidance Agreements ('DTAA's' / 'tax treaty') with Australia, UK, USA, etc., partnership firms are also covered.
- It suggests 'Principal to Principal relationship'.
- It excludes industrial and commercial activities that are covered under the Article on Business Profits.
- It also excludes professional services while in employment which are covered under the Article on Dependent Personal Services.
- Income of Artists, Athletes and Sportsmen, etc. is not covered by this Article. Also, income from Fees from Technical Services is also not covered.
- The Article combines the effect of Article 5 & 7.

14.3 Applicability of the Article

This Article generally covers services of independent nature and therefore, can be said to have been essentially dealing with those persons who are capable of rendering such services. It typically refers to professionals practising in their individual capacity or in partnerships. e.g. the

professional Chartered Accountants carrying on practice.

Considering that there are various forms of entities through which professional services can be rendered, some DTAA's such as India-USA DTAA and India-UK DTAA cover services rendered by partnership firms also. Terms used in these two DTAA's are as under:

India-USA DTAA

'Income derived by a person who is an individual or firm of individuals (other than a company) who is a resident.....'

India-UK DTAA

'Income derived by an individual, whether in his own capacity or as a member of a partnership, who is a resident.....'

A company/other form of body corporates generally are not perceived to be capable of rendering services that can be regarded as 'personal'. Fees received by such corporates are, therefore, normally treated as industrial and commercial profits. Accordingly, one could contend that this Article would not generally apply to the companies²²⁷. However, some treaties include non-individuals within the ambit of this Article. In the context of India-UK DTAA, it has been held that the expression 'resident of a contracting state' is not confined to individual residents but also extends its scope to non-individuals²²⁸ such as a company²²⁹, a partnership firm²³⁰ by way of aggregated presence of the members of such firm. The Mumbai Tribunal has however held in the case of Linklaters LLP²³¹ that Article 15 of the India-UK DTAA will find application when professional services are rendered by an individual, and when services are rendered by an enterprise, Article 5(2)(k) of the DTAA will come into play.

The Delhi High Court in case of Paper Products Ltd²³² had an occasion to examine the provisions of this Article. Under the erstwhile India-Italy DTAA, the provisions of Article 15 contained the term "*Income derived by a resident of a contracting State*". Thus the tax was sought to be levied in respect of an Italian company providing erection, assembly and commissioning services in India. The Hon'ble High Court of Delhi held that the Italian company is not liable to pay tax in India, on analysis of the provisions of Article 15, owing to non-fulfilment of the number of days stay in India. Though the said ruling is suggestive of the application of this Article to Companies, one could, based on the same, still contend the applicability of the Article to Companies providing professional services as well.

Prof. Klaus Vogel in his commentary²³³ observes that:

²²⁷Christiani & Nielson v. ITO (1991) (39 ITD 355) (Bom) [in the context of India-Denmark DTAA]

²²⁸ Maharashtra State Electricity Board v. DCIT (2004) (90 ITD 793) (Mum ITAT)

²²⁹BSR & Company (2016) 182 TTJ 544 (Mum ITAT)

²³⁰Clifford Chance (2009) 318 ITR 237 (Bom HC)

²³¹(2010) 40 SOT 51 (Mum ITAT)

²³²(2002) (124 taxman 012)

²³³Klaus Vogel on Double Taxation Conventions – Third Edition (Page 858)

“...According to OECD and UN MCs²³⁴, companies and other bodies of persons, too, may thus be capable of deriving income from professional services, irrespective of whether or not domestic law- for instance, under the substance vs. form principle – would attribute income of the type in question to a non-individual (unclear:OstVwGH40 OstZb 279 (1987). However, the situation is different under the US MC that restricts to individuals its rule on the taxation of income from personal services.....”

Bengal NRI Complex Ltd (2018) ITA Nos. 1290, 1088/Kol/2014 (Kol ITAT)

The Kolkata Tribunal held that payments made to an individual resident of Dubai for procurement of drawings, will be liable for residence based taxation in terms of Article 14 of the India UAE DTAA.

Price water house Coopers LLP USA (2018) 91 taxmann.com 444 (Kol ITAT)

Where the Assessing Officer had made due enquiries with regard to receipts of assessee from services rendered outside India, which receipts were not taxable in India under Article 15 of the DTAA between India and USA, exercise of jurisdiction under section 263 was not justified.

Taking a broad-based view, the applicability of this Article can be said to extend to not only individuals but also to other non-individual taxpayers providing professional services.

14.4 ‘Professional services’ or ‘other activities of independent character’

Paragraph 2 of the Article provides an inclusive definition of ‘professional services’ covering especially independent scientific, literary, artistic, educational or teaching as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants. The definition is inclusive, and the enumeration has an explanatory character only and is not exhaustive.

The Article is concerned with what are commonly known as professional services and with other activities of an independent character. This excludes industrial and commercial activities and also professional services performed in employment e.g. doctor serving as a medical officer in an organization or a factory. When services are performed as an employee, this Article does not apply but Article on dependent personal services would apply. On the other hand, if services performed are on the principal-to-principal basis this Article would apply.

The crux is that, the services are personal in nature, and the person who is rendering the services is independent.

A profession will imply any vocation carried on by an individuals, or group of individual, requiring predominantly intellectual skills, dependent on individual characteristics of the person pursuing that vocation, requiring specialised and advanced education or expertise.²³⁵ What is contemplated is the services of personal nature i.e. activities that are intellect driven. It

²³⁴Model Commentaries (MCs)

²³⁵Maharashtra State Electricity Board v. DCIT(2004) (90 ITD 793) (Mum)

encompasses professional knowledge of some department of science or learning being used. A person providing professional services is generally understood to possess:

- An advanced level of knowledge acquired through formal training in the chosen practice area (though this may not be a necessary condition)
- Specialised skill sets and experience acquired through dedicated practice in the chosen area; or
- Accreditation to/a certificate of practice issued by a relevant professional body.

Accordingly, any vocation that satisfies the above tests may be said to be falling within the meaning of the income dealt with by this Article though may not be specifically listed.

The wording 'other activities of an independent character' would provide that the definition would encompass many other services not specifically mentioned in the Article. It covers independent activities involving skills, exportation of skills, most commonly known as professional skills. It appears that persons, rendering services as regular independent practice, though not belonging to qualified learned profession would also be covered by this Article. For example, beautician, photographer, etc. would be able to take shelter in this Article. Indian DTAA by and large uses the term 'other services of similar character'.

Prof. Klaus Vogel in his commentary²³⁶ states as under:

*“All this taken together allows the term ‘other activities of an independent character’, as used in Article 14 MC, to be summed up in the form of **two conditions**. What is involved must (first) be a **service** – as distinct from the manufacture or processing of goods by industrial methods or by craftsmanship, and distinct from commercial activities – where (second) the input of **capital** is of no more than **secondary importance**. MC 63 laid down a further (third) condition, viz. that the ‘other independent activities’ had to be ‘**similar**’ to **professional services**. In other words, the services involved had to require a certain qualified training or creative ability.”*

Unlike commercial and business activities where capital requirement might be a critical aspect, IPS requires high amount of intellectual capital and personal expertise to render services. A professional is required to possess certain specialised qualification and training.

In a nutshell, the following factors would aid in determining what activity/services can be covered under “Other activities of an independent character”

- It should be particularly distinguished from business profits within the meaning of the Article 7.
- It should be a service.
- The input of capital is of no more than secondary importance.
- It should be similar to professional services.

²³⁶Klaus Vogel on Double Taxation Conventions – Third Edition (Page 859)

Further, the Article excludes the following:

- Industrial or commercial activities;
- Services performed by an employee who is covered by the Article 15 (Dependent Personal Services);
- Independent activities that are covered by more specific provisions of Article 16 and 17 (e.g. non-employee director, artists, sportsman, etc.);
- Payments to an enterprise in respect of furnishing by that enterprise of the activities of employees or other personnel that are subject to Article 5 and 7. The remuneration paid by the enterprise to the individual who performed the activities is subject either to Article 14 (if he is an independent contractor engaged by the enterprise to perform the activities) or Article 15 (if he is an employee of the enterprise)²³⁷;
- Income from immovable property used for IPS is taxable under the Article 6;
- Capital gains on sale of property used for IPS is taxable under the Article 13;
- Income from services derived by the exploration of rights and similar properties is taxable under the head Royalty/FTS (i.e. Article 12).

14.5 Taxability of IPS

According to Model Conventions, the income from professional services or other activities of independent character is taxable in the country of residence of the receiver of income. In other words, the country of residence has the primary right to tax income falling within this Article.

However, the country in which is income is sourced, also gets a right to tax such income if, a fixed base is regularly available in that country to the recipient earning such income. Income to the extent attributable to such a fixed base is only taxable in the country of source. As per erstwhile OECD Model, this was the only criterion that gave right to country of source to tax the income.

Under UN Model, the country of source also has right to tax income falling within this Article if the taxpayer is present in the country of source for more than 183 days in any twelve month period commencing or ending in the fiscal year concerned. However, only income derived in the source country can be taxed.

In UN Model (1980), several members from developing countries had proposed a third criteria, namely the amount of remuneration. According to this criterion, amount could be taxed by the country of source regardless of the existence of a fixed base or the length of stay of the recipient in that country; if the remuneration for services performed in source exceeded certain amount (to be determined by bilateral negotiations) and if the payer is resident of the country of source or permanent establishment or fixed base situated in source country.

It was subsequently observed that monetary ceiling fixed in this behalf becomes meaningless over a period due to inflation and would only have the effect of limiting the amount of potentially

²³⁷Para 9 of UN Model Commentary

valuable services that the country will be able to import. It was, accordingly, decided to delete this criteria. Pursuantly, this criteria was deleted in the UN Model (2001). Nonetheless, this provision is still adopted by various countries in its tax treaties.

India also has some of the DTAA's that contain similar Article. For example, Indo-Canada DTAA provides that income falling under this Article shall be taxed by source country if the transaction value exceeds an amount of Canadian dollar 2500 (or its equivalent in Indian currency).

14.6 Fixed Base

The Article provides that the income falling within the scope of this Article may also be taxed in source country if:

- There is a fixed base in source country; and
- Such fixed base is regularly available for the purpose of performing his activities.

The term 'fixed base' is used in this Article as against 'permanent establishment' (which is elaborately defined in Article 5). The words 'fixed base' is not specifically defined. However, broad meaning would be required to be given to this phrase. A fixed base should be understood as akin to a place wherefrom a person rendering professional services can operate. It may cover, for instance, consulting room for a doctor or office for an architect or a lawyer or an accountant, etc.

Even if the person performing independent personal services does not have office of his own in the country where service is rendered, but has in his possession/ at his disposal a place for performing his activities which is fixed or more or less permanent in character, then, such facility may be termed as availability of fixed base. For example, a CA of UK, who advises to his Indian clients, has definite office space (cabin) available to him in one of his associates CA firms in India. He can operate from such definite place whenever he visits India. In such a case, it would be possible to contend that CA of UK has fixed base available to him in India.

It is important to note that a fixed base should be 'regularly available' to the person performing independent personal services. It encompasses situations where a fixed base is at the disposal of the service performer, a fixed or permanent facility, rather than facility only for temporary use. The decisive point is the intention underlying the setting up of the facility. Also, what is required is only availability of fixed base for performing services, and it is not necessary for the fixed base to be in the continuous use of a person. Moreover, to be 'available' does not mean that the person performing services must be the owner of the same.

To summarise, the basic requirements for considering a place as a fixed based are:

- The facility must be of a permanent character;
- It must be a fixed location;
- It must be regularly available and is at the disposal of the service provider; and
- It must be available for performing professional services.

Some illustrations of a fixed base are provided below:

Fixed Base	No fixed base
Office of an Architect / Lawyer Physician provided consulting room twice a week by polyclinic Definite space in the office of an associate A Lawyer exercising profession from a second home in another country.	Auditor provided room at client's place to perform audit Desk made available to the manager situated in another enterprise without presence of necessary infrastructure Temporary camping by a researcher at base camp in the Himalayas

14.7 Fixed base vs. Permanent Establishment

As per the source rule, the country of the source can tax income in the hands of the recipient if there is a fixed base available to the recipient in such country of source. Similar provisions exist for determining taxability of business income having reference to a permanent establishment. In both the cases, what is sought to be achieved is, where income is derived by the recipient having economic connection either in the form of fixed base or permanent establishment; then such country acquires right of taxation of income arising therefrom. Analysing from this perspective, fixed base and permanent establishment appear to be a similar concept.

The OECD Model Convention has deleted Article 14 on IPS (on 29 April 2000) pursuant to the recommendations of Committee on Fiscal Affairs because; it was contended that there was no rationale for having separate Articles in respect of business and profession, as both could be covered by Article 7. Differences arising out of the concept of permanent establishment and fixed base will thus disappear if the revised convention is adopted. However, most countries have adopted the earlier model having two distinct Articles, one for business and other for profession.

Having said so, one needs to take into consideration the fact that the wordings accompanied with the term permanent establishment under Article 5 differ considerably from the wordings accompanied with the term fixed base in Article 14. Article 14 refers to '*a fixed base regularly available*' whereas Article 5 defines permanent establishment to mean '*fixed place of business through which business of an enterprise is carried on*'.

It is apparent that mere availability of a regular fixed place is sufficient for the purposes of Article 14 whereas conducting business using such fixed place is the essence of Article 5. In other words, it is not necessary for the fixed base to be used by the service performer continually. Longer duration of a place of business may be essential to demonstrate that such place has become a fixed one. Whereas shorter duration of existence of a professional base may be sufficient to establish the same as fixed base. Prof. Klaus Vogel in his commentary observes that the tax authorities have required shorter times for IPS compared with business and industrial activities. This indicates fixed base for IPS is of a lower degree of permanence.

Prof. Klaus Vogel in his commentary²³⁸ observes as under:

*“.....the fixed base must be ‘regularly’ available to the person performing the independent personal services. In this regard, it **differs** considerably **from the permanent establishment**. For the latter, one requirement is that the business of the enterprise must be carried on in the fixed place of business. In contrast, the fixed base need only be **available** for his purposes to the person performing the services. In other words, it is not necessary for the fixed base to be used by him continually..... ‘to be available’ does not mean that the person providing the services must be the owner of the fixed base...”*

The physical presence of a person rendering services through fixed base is also an issue of debate. Unlike the requirement of Article 7 dealing with business profits where a permanent establishment can exist in the form of machines or pipelines, IPS under Article 14 requires individual persons to render services. The physical presence need not be of the professional person himself but could be that of his assistants and juniors who could accomplish the work in the source country either in part or full, if attribution of income arising out of such services is to the fixed base.

With the advent of computerisation, electronic media and technology used in e-commerce the results can be achieved from a distance without physical presence. In light of the same, fresh look is needed to the principle enunciated above.

Further, services in relation to building or construction project can be permanent establishment but cannot be fixed base. Similarly, arguably fixed base cannot be constituted by a mere agent empowered to contract.

Furnishing of services is also covered by Article 5(3)(b) viz. Service PE. Such Article generally applies to services other than IPS. It refers to furnishing of services by an enterprise through employees or other personnel engaged by the enterprise. Thus, it more precisely covers employees engaged by an enterprise.

Having distinguished the said concepts, one could contend that though not synonymous, the provisions of Article 14 are broadly similar to those for business profits. Thus, the application and interpretation of Article 14 can largely be guided by commentary on interpretation and application of Article 7. The principles laid down in Article 7 for allocation of profits between Head Office and Permanent Establishment could be applied in apportioning income between country of residence of person performing the IPS and country where the source or fixed base is located. The commentary on Article 7 would also be useful in determining allowability of expenses related to fixed base, characterization of income [i.e. whether an income is commercial income or personal services or royalties/fees for technical services (‘FTS’) etc.]

UN Model Commentary in paragraph 10 imports the erstwhile Commentary of OECD Model Commentary with respect to attribution of income to a fixed base in the following words.

“.....Thus the principles laid down in Article 7 for instance as regards allocation

²³⁸Klaus Vogel on Double Taxation Conventions – Third Edition (Page 862)

of profits between head office and permanent establishment could be applied also in apportioning income between the State of residence of a person performing independent personal services and the State where such services are performed from a fixed base. Equally, expenses incurred for the purpose of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment.”

14.8 Duration of stay

The Article provides that income falling within the scope of this Article may also be taxed in source country if:

- The stay in the source country is for a period or periods exceeding in aggregate 183 days in a 12 month period and
- The 12 month period commences or ends in the fiscal year concerned.

The period of twelve months is a rolling period. The same is to be counted forward and backward with reference to any day falling within the fiscal year concerned. Eg. if the year April 2012-March 2013 is the concerned fiscal year, then twelve month period beginning with any day in May 2011 and ending with any day in April 2012 would be covered. Similarly, the period beginning with any day in March 2013 and ending with any day in February 2014 would also be covered. Therefore, in span of May 2011 to February 2014, if in any twelve months period a person has stayed in source country for more than 183 days, then his income for the fiscal year 2012-2013 falling within the scope of this Article may also be taxed in source country.

Similarly, if an individual is present in source country for last 4 months in year 1 and first 3 months in year 2, he would satisfy the condition of '183 days in a 12 month period'. Similarly, if an individual stayed in source country for 182 days during the fiscal year 2012-2013 and 1 day during the fiscal year 2013-14, he would be taxable in source country in both the years.

Subparagraph (b) to UN Model Convention as amended in 1999, extended the source country's right to tax by providing that the source country may tax if the individual is present in the country for a period or periods aggregating at least 183 days in any twelve-month period commencing or ending in the fiscal year concerned, even if there is no fixed base. Only income derived from activities exercised in that country, however, may be taxed. Earlier, prior to such amendment, the requirement of minimum stay in the source country was a “*period or periods amounting to or exceeding in aggregate 183 days in the fiscal year concerned*”. This condition provided for looking at the number of days stay with reference to a fiscal year concerned and the concept of rolling period was not there. India has signed many DTAA during the time when the amendment was not effected and therefore, many of its DTAA do not have the concept of rolling period but are on the basis of phraseology used prior to the amendment.

The number of days stay also differs in DTAA with different countries. For example, in Indo-USA DTAA the requirement of stay is ‘90 days in relevant taxable year’. Similarly, in Indo-UK DTAA the requirement of stay is ‘90 days in relevant fiscal year’. Indo-Korea treaty does not

have this clause at all. The list of number of days provided in various tax treaties signed by India is provided in Annexure B below.

In case of a firm, what is contemplated is a member. The word member used is to be interpreted as any person engaged in professional work and not confined to a partner of a firm²³⁹.

In case of an individual, it is possible to count the number of days presence in a particular country. However, in case of a firm, it is not the firm but the members of the firm who execute the service. E.g. there may be various members of a firm working on the same project in the source country. In such cases, a question may arise regarding the counting of number of days stay of the firm/members in the source country.

In case of India-UK DTAA, there is a clarification for calculating the number of days of presence in case of the firm. According to this clarification, in calculating number of days of presence of the firm in the country of source, number of days of stay of all the members of the firm is to be aggregated. In case, two or more partners are present in source country on the same days, they are to be counted only once.²⁴⁰

In computing the number of days, multiple counting of common days is to be avoided. Multiple counting could result in a stay exceeding even 365 days in a year. The same is not permitted. Thus, it is the 'solar days' and not 'man days' that are to be taken into account.

14.9 Article 14 vs. Article 12

It is possible that FTS might also include professional services. In such context, whether Article 12 (dealing with FTS) would apply or would Article 14 have precedence is an issue of debate. In this context, it is pertinent to consult the judicial precedence.

It has been held by various courts²⁴¹, that once the services are covered as IPS under Article 14 then it is immaterial whether or not the same is covered by the FTS of Article 12. In other words, if more beneficial provisions are available to a taxpayer, application of lesser beneficial provisions would be irrelevant, even though the services might have been covered by the definition of such lesser beneficial provisions.

The Mumbai Tribunal in the case of Maharashtra State Electricity Board v. DCIT²⁴² dealt with the issue in detail. In this case, the assessee entered into an agreement with one 'F', a London-based firm of solicitors, for availing certain 'legal advisory services' in connection with entering into an agreement to purchase power from Enron Project. While seeking Assessing Officer's permission to make remittance in settlement of bills for fees for legal consultancy services the assessee took the stand that the payments being covered by Article 15 of India-UK DTAA and the recipient firm having spent less than 90 days in India, said payments of legal fees were not eligible to tax in India. The Assessing Officer however, concluded that the payments on account

²³⁹Clifford Chance v. DCIT (2002) (82 ITD 106) (Mum)

²⁴⁰Clifford Chance v. DCIT (2002) (82 ITD 106) (Mum)

²⁴¹ABC Bearing Ltd[2017] 78 taxmann.com 62 (Mumbai - Trib.), Susanto Purnamo (2016)73 taxmann.com 108 (Ahd Trib), Clifford Chance [2013] 154 TTJ 537 (Mumbai - Trib.) (SB), Dieter Eberhard Gustav Van Der Mark v. CIT (1999) (235 ITR 698) (AAR) & Graphite India Ltd. v. CIT (86 ITD 384) (Kol ITAT).

²⁴²(2004) (90 ITD 793) (Mum ITAT)

of legal consultancy charges were in the nature of FTS covered by Article 13 of India-UK DTAA, and, accordingly, the assessee was required to deduct tax at source.

The Mumbai Tribunal held that any services in the nature of legal consultancy services inherently involve either purely intellectual skills of the person(s) rendering those services or of any manual skill, as in painting or sculpture or surgery, skill controlled by the intellectual skill of the person(s) and thus such services rendered are distinctly in the nature of professional services.

It held that once the services in question constitute 'professional services', the natural corollary is that the provisions of IPS Article are to be applied which specifically deal with 'professional services'. The provisions of IPS Article, being specific provisions for professional services, will override the relatively general provisions of FTS Article and will apply to a broader category of 'managerial, technical or consultancy services'.

While dealing with the scope of services which are covered by article 15, it is important to bear in mind the fact that there could indeed be overlapping effect of the scope of services covered by the other articles but as long as the services are rendered by an individual or group of individuals, generally rendition of such services is covered by article 15²⁴³.

Having discussed the issues around this topic the broad take-away would be:

- Article 14 is a specific provision dealing with IPS and specific skill sets/ professional qualifications for the performance of services is required to attract taxation of services under this head.
- The performance of professional services under a contract of employment would not be covered under the purview of this Article and would be covered under Dependent personal services clause.
- The Article covers services provided both by individuals as well as non-individuals (subject to specific wordings of DTAA)
- The Country of Source gets the right to tax the income in the hands of the recipient only if:
 - (a) *Recipient of income has a fixed base regularly available in such country or*
 - (b) *The number of days of stay in such country is in excess of the days provided in DTAA*
- The Attribution of profits to the source country would be guided by rules of attribution similar to a Permanent Establishment.
- The provisions of IPS Article, being specific provisions for professional services, will override the relatively general provisions of FTS Article and will apply to a broader category of 'managerial, technical or consultancy services'.

²⁴³Susanto Purnamo (2016)73 taxmann.com 108 (Ahd Trib)

Article 14 - INDEPENDENT PERSONAL SERVICES

OECD MC (Old)	UN MC	US MC
1) Income received by a resident of a Contracting State in respect of Professional Services or other activities of an independent character shall be taxable only in that state.	1. Same as OECD MC	<ul style="list-style-type: none"> • Talks about an individual who is a resident & • Performance of personal services in an independent capacity. (no reference to "Professional")
2) However such income will be taxable in the other Contracting State only if the resident of the Contracting State has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities & only to the extent of the income that can be attributable to that fixed base.	2. Circumstance when income will be regarded as taxable in the other Contracting State (say India) : <ol style="list-style-type: none"> a) Same as Para 2 of OECD MC Additional non-cumulative conditions b) If the non-resident's aggregate stay in India is for more than 183 days in any Fiscal year (April to March) than so much of the income as is derived from his activities performed in India will be taxable in India. c) If the remuneration for non-resident's activities in India is paid by a resident of India or is borne by a PE or FB situated in India & exceeds in the fiscal year Rs..... (amount to be established through bilateral negotiations). 	Same as OECD MC
The term "professional	3. Definition of Professional	3. Definition of

OECD MC (Old)	UN MC	US MC
services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.	services is the same as OECD MC	Professional services is the same as OECD MC

COMPARITIVE STUDY AMONGST VARIOUS DTAA's ENTERED INTO BY INDIA

Notes:

1. Mostly all the treaties are based on UN Model.
2. Taxability based on 'a Fixed Base' criterion is a common condition in all the treaties.
3. In most of the treaties Independent Personal Services are covered under Article 14, however in case of the following treaties it is covered under Article 15 :
 - (a) *Bangladesh,*
 - (b) *Botswana,*
 - (c) *Bulgaria,*
 - (d) *Denmark,*
 - (e) *France,*
 - (f) *Israel,*
 - (g) *Italy,*
 - (h) *Malaysia,*
 - (i) *Montenegro,*
 - (j) *Namibia,*
 - (k) *Philippines,*
 - (l) *Poland,*
 - (m) *Serbia,*
 - (n) *Spain,*
 - (o) *UAR (Egypt)*
 - (p) *United Kingdom,*
 - (q) *Uzbekistan,*
 - (r) *United States of America,*
 - (s) *Vietnam,*
 - (t) *Zambia*
4. India amended its tax treaty with Romania wherein following amendments have been made in Article 14 –

- The revised tax treaty has included the **services rendered by entities other than individuals** within the ambit of this Article.
- Professional services covered under this Article include independent service of auditors

5. The below table provides broadly the applicability of the Article and its conditions related to taxability of the income in the source state (other than the condition of fixed base) in various tax-treaties signed by India²⁴⁴:

Note: In the table below – (a), (b), (c) and (d) refers to the following:

- a. *Stay by the resident in the other Contracting State for a period or periods exceeding 183 days in the aggregate in any twelve month period/the relevant fiscal/previous year.*
- b. *Stay by the resident in the other Contracting State for a period or periods exceeding 120 days in the aggregate in the relevant fiscal/previous year.*
- c. *Stay by the resident in the other Contracting State for a period or periods exceeding 90 days in the aggregate in the relevant fiscal/previous year.*
- d. *Resident of a Contracting State.*

Sr. No.	Country	Applicability	Taxability
1.	Albania	Applies to Individual only	(a)
2.	Armenia	Applies to Individual only	(a)
3.	Australia	Individual or a firm of individuals (other than a company)	(a)
4.	Austria	Applies to Individual only	(a)
5.	Bangladesh	(d)	(b)
6.	Belarus	(d)	(a)
7.	Belgium	Applies to Individual only	(a)
8.	Bhutan	No IPS Article	
9.	Botswana	Applies to Individual only	(a)
10.	Brazil	(d)	Fully taxable in India if borne by a

²⁴⁴One may need to refer to the specific wordings of the each tax treaty while evaluating the taxability.

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Sr. No.	Country	Applicability	Taxability
			resident of India or a PE in India
11.	Bulgaria	Applies to Individual only	(a)
12.	Canada	Individual or a firm of individuals (other than a company)	(a) or Remuneration exceeds two thousand five hundred Canadian dollars (\$2,500) or its equivalent in Indian currency in the relevant fiscal year
13.	China	(d)	(a)
14.	Columbia	Applies to Individual only	(a)
15.	Croatia	(d)	(a)
16.	Cyprus	(d)	(a)
17.	Czech Republic	(d)	(a)
18.	Denmark	Applies to Individual only	(a)
19.	Estonia	Applies to Individual only	(a)
20.	Ethiopia	Applies to Individual only	(a)
21.	Fiji	Applies to Individual only	(a)
22.	Finland	Applies to Individual only	(a)
23.	France	Individual or a partnership of individuals who is a resident of a Contracting State	(a)
24.	Georgia	Applies to individual only	(a)
25.	Germany	Applies to individual only	(b)

Sr. No.	Country	Applicability	Taxability
26.	Greece	Applies to individual only	(a)
27.	Jordan	(d)	(a) or Remuneration exceeds equivalent of US \$ 2000 in the relevant fiscal year
28.	Hungary	(d)	(a)
29.	Iceland	(d)	(a)
30.	Indonesia	(d)	If residents stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 91 days in any twelve month period
31.	Ireland	(d)	(a)
32.	Israel	(d)	(a)
33.	Italy	(d)	(a)
34.	Japan	(d)	(a)
35.	Kazakhstan	(d)	(a)
36.	Kenya ²⁴⁵	(d)	(a)
37.	Korea	Applies to Individual only	Fixed base criteria only
38.	Kuwait	Applies to Individual only	(a)
39.	Kyrgyz Republic	(d)	(a)
40.	Latvia	Applies to Individual only	(a)
41.	Libya ²⁴⁶	(d)	Fixed base criteria only
42.	Lithuania	Applies to Individual only	(a)
43.	Luxembourg	Applies to Individual only	(a)

²⁴⁵Article 16

²⁴⁶Article 12

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Sr. No.	Country	Applicability	Taxability
44.	Malaysia	Applies to Individual only	(a)
45.	Malta	(d)	(a)
46.	Mauritius	(d)	Fixed base criteria only
47.	Mongolia	(d)	(a)
48.	Montenegro	Applies to Individual only	(a)
49.	Morocco	(d)	(a)
50.	Mozambique	Applies to Individual only	(a)
51.	Myanmar	Applies to Individual only	(a) or Remuneration exceeds US \$ 16,000 in the fiscal year
52.	Namibia	Applies to Individual only	(a)
53.	Nepal	Applies to Individual only	(a)
54.	Netherlands	(d)	(a)
55.	New Zealand	Applies to Individual only	(a)
56.	Norway	Applies to Individual only	(a)
57.	Oman ²⁴⁷	(d)	(a)
58.	Uruguay	Applies to Individual only	(a)
59.	Philippines	(d)	(a)
60.	Poland	Applies to Individual only	(a)
61.	Portuguese Republic	(d)	(a)
62.	Qatar	(d)	(a)

²⁴⁷Article 16

Sr. No.	Country	Applicability	Taxability
63.	Romania	(d) ²⁴⁸	(a)
64.	Russia	Applies to Individual only	(a)
65.	Saudi Arabia	Applies to Individual only	(a)
66.	Serbia	Applies to Individual only	(a)
67.	Singapore	Applies to Individual only	(c)
68.	Slovenia	Applies to Individual only	(a)
69.	South Africa	Applies to Individual only	(a)
70.	Spain	(d)	(a)
71.	Sri Lanka	Applies to Individual only	(a)
72.	Sudan	Applies to Individual only	(a)
73.	Sweden	(d)	(a)
74.	Swiss Confederation	(d)	(a)
75.	Syrian Arab Republic	Applies to Individual only	(a)
76.	Tajikistan	Applies to Individual only	(a)
77.	Tanzania	Applies to Individual only	(a)
78.	Thailand	(d)	(a)
79.	Trinidad and Tobago	(d)	(a) or Remuneration exceeds Rs. 40,000 or its equivalent in Trinidad or Tobago

²⁴⁸ Romania treaty has been revised by way of Notification No. 13/2014 dated 5 March 2014 wherein it has amended the clause which provides that “Income derived by a resident of a contracting state” i.e. it may cover Individual, Partnership firm, company, LLP, etc.

Sr. No.	Country	Applicability	Taxability
			currency
80.	Turkey	Applies to Individual only	(a)
81.	Turkmenistan	(d)	(a)
82.	UAE	(d)	(a)
83.	UAR (Egypt)	(d)	(a)
84.	Uganda	(d)	(a)
85.	UK	Individual, whether in his own capacity or as a member of a partnership	(c)
86.	Ukraine	Applies to individual only	(a)
87.	United Mexican States	Applies to individual only	(c)
88.	USA	Individual or firm of individuals (other than a company) who is a resident of a Contracting State	(c)
89.	Uzbekistan	(d)	(a)
90.	Vietnam	(d)	(a)
91.	Zambia	(d)	(a) or Remuneration exceeds K 10,000 or its equivalent in Indian currency

14.10 Latest Judicial Pronouncements

Poddar Pigments Ltd. v. ACIT 2020] 117 taxmann.com 728 (Delhi - Trib.)

Assessee-company was engaged in business of manufacturing of master batches and engineering plastics compounds. It made payment to two foreign scientists for professional services rendered by them. Co-ordinate bench in assessee's own case for earlier years found that services had been provided by individuals which were in nature of Independent scientific services covered under article 14. According to article 12(5)(b) meaning of term fees for technical services specifically excludes income covered under articles 14 and 15; and that two

scientists had no fixed PE in India and both had not stayed in India for 183 days or more. Since the two conditions were not met, tax was not required to be deducted at source by assessee while making payment to two scientists.

15. Article 15 –Dependent Personal Services

15.1 Background

Businesses are no longer restricted to the local geographical boundaries. With globalisation and liberalisation, the modern day businesses have spread their reach out of their home countries. MNCs are looking to capture every business opportunity available on this planet. We will witness a high inclination in mobility of employees to India, being one of the top investment destinations.

International assignment can help draw as well as secure the talent, all while providing individuals with new skills, opportunities for international travel, new challenges and the experience needed to progress their careers. This change has led to movement of personnel for the purpose of employment beyond the country of domicile. Such movement has triggered issues relating to taxation of remuneration received by these personnel. The tax treaties between the countries have specifically tackled these issues in order to facilitate business ties and eliminate double taxation. Double Tax Avoidance treaties ('treaties') entered between countries address these issues through Article 15/16 titled "Dependent Personal Services" ('DPS'). This needs to be read in conjunction with other Articles of the treaty dealing with namely – residence, permanent establishment, independent personal services, government employees and directors.

15.2 History and Scope of the Article

The DPS Article deals with taxation of income earned as reward for employment. Till the year 2000, the OECD Model Article was captioned "Dependent Personal Services". The title of the Article was changed to "Income from Employment" after deletion of the Model Article 14 titled "Income from Independent services". Change in name of the Article seems to have no impact on the scope and coverage of the article. The UN Model continues to refer to the Article as DPS. The treaties also continue with the conventional caption of DPS.

This Article captures the treatment of any remuneration and emoluments earned by an employee from exercise of his employment in a contracting state to the TREATY. Remuneration may be in any form including any emoluments received by the reason of employment. However, certain items of income are governed by other specific clauses of the treaty. These specific clauses administer the taxation of any such remuneration thereby eliminating the applicability of DPS Article of the treaty. OECD model treaty incorporates following exceptions:

- (a) Article 16 – Director's fees
- (b) Article 18 - Pensions
- (c) Article 19 – Government service

There are certain exceptions relating to payments made to artists, sportsmen, professors,

teachers, students and research scholars in employment as well. Any specific Article in the treaty covering these payments will override DPS Article to the extent applicable.

This Article will guide the contracting states to a treaty in ascertaining the correct taxability of employment remuneration in the country of residence as well as the source country. Since treaty is related to international transactions, this Article is applicable to employees performing their services in a country other than the country of their own residence. For eg:

- (a) Employee deputed on assignment outside his own country of residence.
- (b) Employee permanently relocating to a different country for employment.
- (c) Employee required to travel to different countries in course of his employment.

15.3 Taxation of employment income under Income Tax Act, 1961 ('Act')

Salary earned for services rendered in India is taxable irrespective of residential status of an individual and place of receipt of such salary. Therefore, any employment income sourced in India will be liable to tax under the Act. As per section 15 of the Act following amounts shall be chargeable to income tax- under the head "Salaries":

- “(a) any salary due from an employer or a former employer to an assessee in the previous year, whether paid or not;*
- (b) any salary paid or allowed to him in the previous year by or on behalf of an employer or a former employer though not due or before it became due to him;*
- (c) any arrears of salary paid or allowed to him in the previous year by or on behalf of an employer or a former employer, if not charged to income-tax for any earlier previous year.”*

However, the Act also contains a safe harbour for non-residents travelling for a short-term business visit to India under section 10(6)(vi) where the employee of foreign enterprise renders services in India provided following conditions are fulfilled:

- “(a) the foreign enterprise is not engaged in any trade or business in India ;*
- (b) his stay in India does not exceed in the aggregate a period of ninety days in such previous year ; and*
- (c) such remuneration is not liable to be deducted from the income of the employer chargeable under this Act ;”*

If any inbound expatriate satisfies the aforesaid conditions, then remuneration received by such employee will be exempt from tax under the Act.

Section 90 and Section 91 of the Act provide for provisions of avoidance of double taxation in India. As per Section 90 of the Act, an individual who qualifies as a resident of a country in accordance with a treaty executed between India and the other foreign country can opt to be assessed under such treaty if the provisions of the treaty are more beneficial. However, a tax payer claiming any relief under applicable treaty, being a resident of other country, shall not be

entitled to claim any such relief unless a tax residency certificate is obtained by him from the Government of that other country.

15.4 Taxation of employment income under the applicable Tax treaty

Taxability of employment income is governed by Dependent Personal Services/ Income from Employment Article of the treaty.

For reference purposes, DPS Article under OECD Model Convention on taxation is reproduced hereunder:

ARTICLE 15

INCOME FROM EMPLOYMENT

1. *Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.*

2. *Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:*

- (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and*
- (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and*
- (c) the remuneration is not borne by a permanent establishment which the employer has in the other State.*

3. *Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.*

The major points to be taken under consideration for evaluation of taxability of an individual under DPS clause of the treaty are given as under:

- (i) Applicability is restricted to employment income where recipient has employee-employer relationship with the payer
- (ii) Place of exercise of employment
- (iii) Residency of employee Vs. Source Rule

(iv) Exemption from tax in “source country”

15.4.1 Applicability is restricted to employment income where recipient has employee-employer relationship with the payer

The general rule to the taxation of income from employment (other than pensions) is that such income is taxable in the State where the employment is actually exercised. Employer – employee relationship is the pillar on which the applicability of this Article is premised. An employee is a person who makes himself available to his employer to so perform his duties that he submits himself to directions, instructions and superintendence of the employer.

Meaning of Employer as per ‘Klaus Vogel’ on ‘Double Taxation Convention’ is as under:

“An employer is someone to whom an employee is committed to supply his capacity to work and under whose directions the latter engages in his activities and whose instructions he is bound to obey”

In context of India, the Article would cover relationship where income will be taxed under the head “Salaries”. This Article does not cover independent exercise of services where professionals or free lancers provide services on a principal to principal basis pursuant to a contract of service.

An employer is a person on whom the employee has economic and personal dependence.

Illustration 1

An individual who is employed by Mr. X is working in his factory or is deputed at a project site of Mr. X or is on tour as a sales representative of Mr. X, there can be no difficulty in concluding that Mr. X is the real employer. Difficult question may arise in a situation where a person who is engaged by Mr. X but, is deputed to Mr. Y for project site of Mr. Y or in the office of Mr. Y. In such a case, the question to arise would be as to who is the real employer.

In this respect, it should be noted that the term "employer" is not defined in the OECD Convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. In cases of international hiring-out of labour, these functions are to a large extent exercised by the user. In this context, substance should prevail over form, i.e. each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user. The real employer is the user of the labour (and not the foreign intermediary) if :

- the hirer does not bear the responsibility or risk for the results produced by the employee's work;
- the authority to instruct the worker lies with the user;
- the work is performed at a place which is under the control and responsibility of the user;
- the remuneration to the hirer is calculated on the basis of the time utilised, or there is in other ways a connection between this remuneration and wages received by the employee;

- tools and materials are essentially put at the employee's disposal by the user;
- the number and qualifications of the employees are not solely determined by the hirer.

Now, reference can also be drawn to Discussion Draft captioned “Proposed clarification of scope of paragraph 2 of Article 15 of the Model Tax Convention – Public discussion draft” was issued by the OECD initially in April, 2004. The said draft was later revised in March 2007 after considering comments received by the OECD.

One of the factors of relevance highlighted in the draft report is to examine

- (a) Whether the services rendered by the employee constitute an integral part of the business of the enterprise to which he provide the services: (or)
- (b) Whether he performs the service which is core function of the organisation by whom the person is deputed.

The draft report suggests that the following factors be also considered for determining who the real employer is.

- (i) Who has the authority to instruct the individual regarding the manner in which the work has to be performed;
- (ii) Who controls and has responsibility for the place at which the work is performed;
- (iii) The remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided
- (iv) Who puts the tools and materials necessary for the work at individual's disposal;
- (v) Who determines the number and qualifications of the individuals performing the work;

The above drat OECD report has enlisted certain illustrative cases to explain the impact of above factors. We may pick up following examples for the sake of understanding:

Illustration 2

Company X is engaged in the business of providing training services. If any employee of X provides training to the employees of another company Y in the office of Y, X alone is to be regarded as the real employer. Therefore, the trainer employee does not become an employee of the other organization.

Illustration 3

This illustration deals with a situation where an employee is engaged by company A with a clear understanding that the employee has to work at the office of company B and as per instructions of company B. In such a case, the chances are that company B may be regarded as the real employer.

Illustration 4

This example deals with cost contribution arrangement/ centralized function typically prevalent in MNC group.

Mr. A is a resident of state Q (being an employee of a multinational company - ABC) who is appointed as a senior manager in charge of supervising HR functions of the MNC Group. Since the employer company ABC is acting as a centralized HR unit of the Group, cost of ABC is allocated to various group companies based on certain keys. A would be regarded as employee of ABC group even assuming A travels to other site and the entities in the other state would have contributed to ABC in respect of all the costs including salary of Mr. A. The activities performed by Mr. A are a part of the functions which are the functions of ABC and therefore A should be regarded as an employee of ABC

Some of the determining features that have evolved through judicial precedence are as follows:

- **Supervisory Control**
 - Ram Prashad v CIT 86 ITR 122 (SC)
 - Piyare Lal Adishwar Lal v CIT 40 ITR 17 (SC)
- **Master's right of suspension or dismissal**
 - Ram Prashad v CIT 86 ITR 122 (SC)
- **Rules and regulations applicable to other employees of the company**
 - Dr Shanti Sarup Jain v First ITO 21 ITD 494 (Mum)
- **Agreement between parties to be viewed in totality / intention of the parties**
 - Piyare Lal Adishwar Lal v CIT 40 ITR 17 (SC)
 - Dr Shanti Sarup Jain v First ITO 21 ITD 494 (Mum)
- **Employer should be responsible for the work of the employees**
 - Morgan Stanley & Co Inc (2007, 292 ITR 416)(SC)
 - Centrica India Offshore (P.) Ltd.[2014] 364 ITR 336 (Delhi)
- **Employer should bear the remuneration of the employees and it should put the tools and materials necessary for the work at the individual's disposal.**
 - Lakshminarayan Ram Gopal & Son Ltd, Piyare Lal Adishwar, Carborandum Co (1977, 108 ITR 335)]
- **An enterprise providing equipment/ tools to the workers is an important consideration in determining the nature of relationship**
 - Silver Jubilee Tailoring House v Chief Inspector of Shops)
- **Income of the assignees accrues where services are rendered**
 - Hewlett Packard India Software Operation (P) Ltd (2018) 91 taxmann.com 473 (AAR)

Indian Courts have laid down various tests/ factors to determine whether an employee employer relationship exists or not, some of which are illustrated above. However, there are no fix rules and the ascertainment needs to be based on overall facts of the arrangement. Recent trend with

the Indian tax authorities and Indian Courts is to scrutinize such arrangements closely based on the terms of agreements, conduct of parties etc.

15.4.2 Place of exercise of employment

Salary income is taxable in the country where the employment is actually exercised. Employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid, i.e. physical presence of an employee is the pre-condition to exercise of employment.

It is pertinent to note that the following points are not relevant in deciding the exercise of employment:

1. Place where the result of work is exploited
2. Place of signing contract
3. Place of Headquarters of Employer
4. Residence of Employer
5. Nationality of Employee
6. Place of remittance of emoluments

Now, there can be visits in connection with employment as well. These visits need to be analyzed on a case to case basis.

15.4.3 Interpretation of Paragraph 1 of DPS - Residency of employee Vs. Source Rule

In order to explain this clause Paragraph 1 of Article 16 of India and US treaty is reproduced below:

*“....., salaries, wages and other similar remuneration derived by a **resident of a Contracting State** in respect of an employment shall be **taxable only in that State unless the employment is exercised in the other Contracting State**. If the employment is so exercised, such remuneration as is derived there from may be taxed in that other State.”*

Paragraph 1 of DPS recognizes that the country of which the employee is a tax resident as per treaty will have right to tax his salary income. As per this recognition, the state of residence can tax salary income even if it is earned by exercise of employment in some other country. However, if the employment is exercised in some other country, the income may be taxed in that other country as well. To illustrate, salary earned by a person resident of India will be taxable in India even if the employment is exercised in the US. Also, such income may be taxed in the US.

The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee. Salaries, wages and any other similar remuneration are not defined under the Model Convention. Accordingly, the same needs to be understood in accordance with

the domestic law of the respective country (for India, in accordance with the meaning provided under the Act). Given the same, it would cover all forms of remuneration as long as it is connected with the employment exercised, whether received in cash or kind or both, including perquisites like accommodation, motor-car, club membership, stock options, etc.

This Article relates to a typical outbound situation where the person while working on overseas assignment continues to receive salary in India. Such salary income is taxable under Income Tax Act on receipt basis. But as the intention of DPS is to give right to tax to the source country and section 9 also states that salary is taxable in India if services are rendered in India, any salary received by an outbound assignee in India may be considered as not taxable in India if,

- (a) The outbound assignee is a treaty resident of other country and
- (b) Salary received in India is not related to the services rendered in India.

This article may also cover the salary which is received in India by resident of other country for services rendered in any third country.

Mechanics of Article 16(1) – India US Tax Treaty

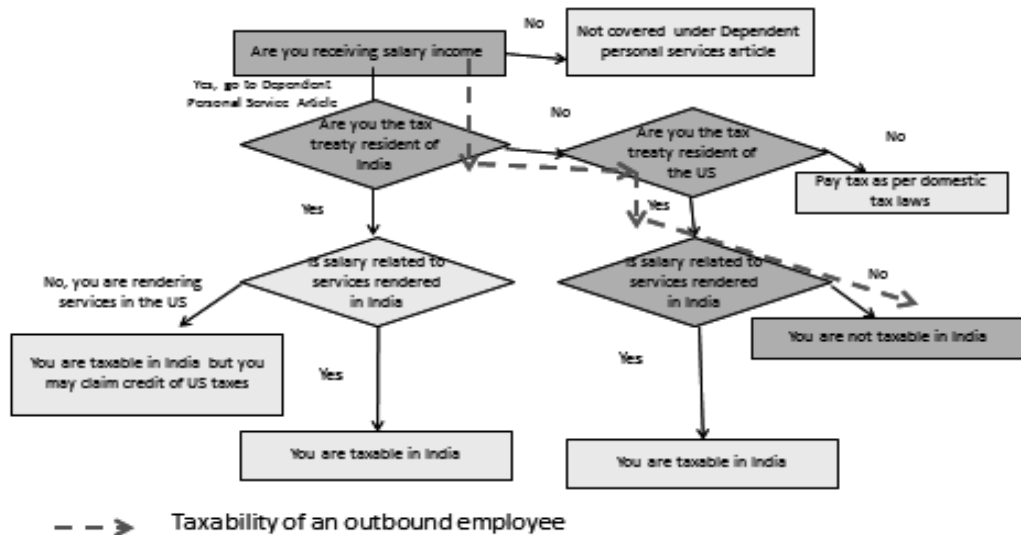


Illustration 5

Mr. X, an Indian national, has gone to US on assignment through his Indian employer. His stay in India during the year of departure to US was 100 days. He continues to receive his salary in India only. Determine taxability in India.

Firstly, since Mr. X's stay in India is less than 100 days he will qualify as a non-resident under the Act. Being a non-resident, he is liable to tax only on his India sourced income and income received in India. However, India may not consider his remuneration subject to tax in India if the payout is not with respect to employment exercised in India. In such a case, there is still a

possibility to claim exemption under DPS clause of India – US treaty provided:

- Mr. X is resident of US
- The salary received in India is in respect of employment exercised outside India.

Since both of the above conditions are satisfied we can claim exemption for the entire amount of salary received in India as it relates to exercise of employment in US. We can claim this benefit under DPS (Article 16(1)) of US-India treaty. Nevertheless, the salary received before start of his assignment relates to exercise of employment in India and is liable to tax in India.

15.4.4 Interpretation of Paragraph 2 of DPS – Exemption from tax in “source country”

In order to explain this clause we have reproduced Paragraph 2 of Article 16 of India and US treaty.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of one of the States in respect of an employment exercised in the other State shall be taxable only in the first-mentioned State if :

- (a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the relevant taxable year, and*
- (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and*
- (c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.*

Paragraph 2 is a general exception to the rule in paragraph 1. This exception covers all individuals rendering services in the course of an employment. This paragraph is generally termed as short stay exemption under a tax treaty. As per this paragraph, the salary income earned by an employee may be considered as not taxable in the source country, subject to satisfaction of three conditions as prescribed under this article explained as under:

India may exempt remuneration from tax derived by a US resident in respect of an employment exercised in India if the following tests are satisfied:

- **Physical residence test:** US resident is present in India during the relevant previous year for 183 days or less; and (physical presence test)
- **Resident employer test:** Remuneration to the US resident is paid by, or on behalf of employer who is not resident in India; and (Resident Employer test)
- **Permanent Establishment test:** Remuneration to the US resident is not borne by PE or Fixed base or business or trade which the employer has in India (PE connect test)

However, if we analyze the other side of the story, this paragraph gives right to taxation to the country in which employment is exercised (viz. source country) if any of the above mentioned conditions are not satisfied. It is pertinent to note that the availability or non-availability of exemption under this paragraph will not affect the taxability in the country of residence.

The tests to be evaluated in order to ascertain whether the exemption under Paragraph 2 would be available are explained in detail below:

I. Physical Residence Test

1963 Draft Convention and the 1977 Model Convention provided that the 183 day period should not be exceeded "**in the fiscal year concerned**", a formulation that created difficulties where the fiscal years of the Contracting States did not coincide and which opened up opportunities in the sense that operations were sometimes organized in such a way that, for example, workers stayed in the State concerned for the last 5 1/2 months of one year and the first 5 1/2 months of the following year. The present wording of subparagraph 2 does away with such opportunities for tax avoidance. Some tax treaties stipulate the condition of 183 day period thus "in any twelve month period commencing or ending in the fiscal year concerned".

In applying that wording, all possible periods of twelve consecutive months must be considered, even periods which overlap others to a certain extent. For instance, if an employee is present in a State during 150 days between 1 April 12 and 31 March 13 but is present there during 210 days between 1 August 12 and 31 July 13, the employee will have been present for a period exceeding 183 days during the second 12 month period identified above even though he did not meet the minimum presence test during the first period considered and that first period partly overlaps the second.

Some of the examples of different wordings used in framing Paragraph 2 of the DPS clause of TREATY are given below:

India – US Tax treaty

*"for a period or periods not exceeding in the aggregate **183 days in the relevant taxable year**"*

India – UK Tax treaty

*"period or periods not exceeding in the aggregate 183 days during the **relevant fiscal year**"*

India – Malaysia Tax treaty

*"for a period or periods not exceeding in the aggregate 183 days in **any twelve month period commencing or ending in the fiscal year concerned**"*

The first condition is that the exemption is limited to the 183 day period. It is further stipulated that this time period may not be exceeded

— "in any twelve month period commencing or ending in the fiscal year concerned"; or

— "in a relevant tax / fiscal year"

The application of this method is straightforward as the individual is either present in a country or he is not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities. Under this method the following days are included in the calculation:

- part of a day,
- day of arrival,

- day of departure
- all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity
- short breaks (training, strikes, lock-out, delays in supplies), days of sickness.

However, days spent in the State of activity in transit in the course of a trip between two points outside the State of activity should be excluded from the computation. It follows from these principles that any entire day spent outside the State of activity, whether for holidays, business trips, or any other reason, should not be taken into account. A day during any part of which, however brief, the taxpayer is present in a State counts as a day of presence in that State for purposes of computing the 183 day period.

Nevertheless, different countries have their own set of tests to compute the said threshold.

For eg:

- Ireland applies the test of stay upto midnight.
- USA takes into account the aggregate of fractional stays on different days and a day's presence is reckoned only when the fractions aggregate to a 24 hour period

Judicial precedents on computing number of days

Day of arrival is to be excluded for calculating number of days - Manoj Kumar Reddy [2011] 201 Taxmann 30 (Kar)[2009] 30 SOT 18 (B'lore) ; Fausta C. Cordeiro [2012] 53 SOT 522. (Mumbai ITAT)

Both days should be counted as "in India". - (233 ITR 462)(AAR)

Only day of departure has to be considered as "in India". - Dr. R. K. Sharma (ITA No. 1230) (Jaipur ITAT)

II. Resident Employer Test

The second condition is that the employer paying the remuneration must not be a resident of the State in which the employment is exercised.

As mentioned earlier the term "employer" is not defined in the Convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. The object and purpose of subparagraphs b) and c) of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a permanent establishment therein.

In order to enhance your understanding please refer to Example 2.

Now, in relation to this example reference can also be drawn from the commentary of Prof. Vogel who has endorsed the possibility of a situation in which both the organizations, viz. A and B, may acquire status of employer. In the case where conclusion on real employer status is inconclusive due to sharing of control by two different countries, the revenue authority of the source country can assert the right to taxation so long as person resident in the source country

can be perceived as one of the two contenders of employer status w.r.t taxation of remuneration paid by or on behalf of such person.

III. Permanent Establishment Test

One of the other conditions that allows the source country to tax the remuneration earned from rendering employment is that the remuneration which is paid to him is borne by the PE that his employer has in the country of source. If this condition is fulfilled, the source country gets the right to tax the income earned from employment irrespective of the duration (ie even if the duration is less than 183 days).

The rationale behind this provision is that where the PE bears the expenditure, the remuneration paid to employee is taxed by the source state as a corresponding deduction is allowed to the PE while computing its taxable income. The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph *c) of the Article*, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that could give rise to a deduction, having regard to the principles of Article 7 and the nature of the remuneration, in computing the profits of a permanent establishment situated in the State in which the employment is exercised.

Klaus Vogel in his book "Double Taxation Conventions" states that "remuneration for DPS is considered to have been borne by a PE or a fixed place if it can be claimed as a deduction for business expenses when calculating the profits to be attributed to a PE".

Based on the above, the expression "borne by" is to be interpreted as to whether the remuneration paid is deductible in computing the profits of home entity in India. Even in cases where no deduction may be availed while calculating business profit in respect of remuneration paid to the individual, the following excerpt of OECD commentary should be considered -

"it must be noted that the fact that the employer has, or has not, actually deducted the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether the remuneration would be allowed as a deduction for tax purposes; that test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled."

In this regard, it must be noted that the fact that the employer has, or has not, actually claimed a deduction for the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether any deduction otherwise available for that remuneration would be allocated to the permanent establishment. That test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled.

The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment.

In contrast, the word '**deductible**' would mean whether the remuneration paid to the employee can be claimed as a deduction in computing the taxable income of the PE. In that regard, it would not be relevant as to whether the liability to pay the remuneration was incurred by the PE or not. It would also not matter as to whether or not, the PE actually claims the remuneration as a deduction in computing its profits. Accordingly, it ought to be interpreted that the meaning of the word 'deductible' is wider than the term 'borne'.

Judicial precedents on 'borne by'

PE is commercially liable or actually pays for the expense - EnSCO Maritime Ltd (2004) 91 ITD 459 (Del), Elitos S.P.A (2005) 145 Taxman 210 (All)

Expense has a direct and proximate connection with PE and is deductible in hands of PE. (also includes presumptive taxation cases in which such expense is deemed to have been allowed) - DHV Consultants BV 277 ITR 97 (AAR), Lloyd Helicopters International Pty. Ltd., [2001] 249 ITR 162 (AAR)

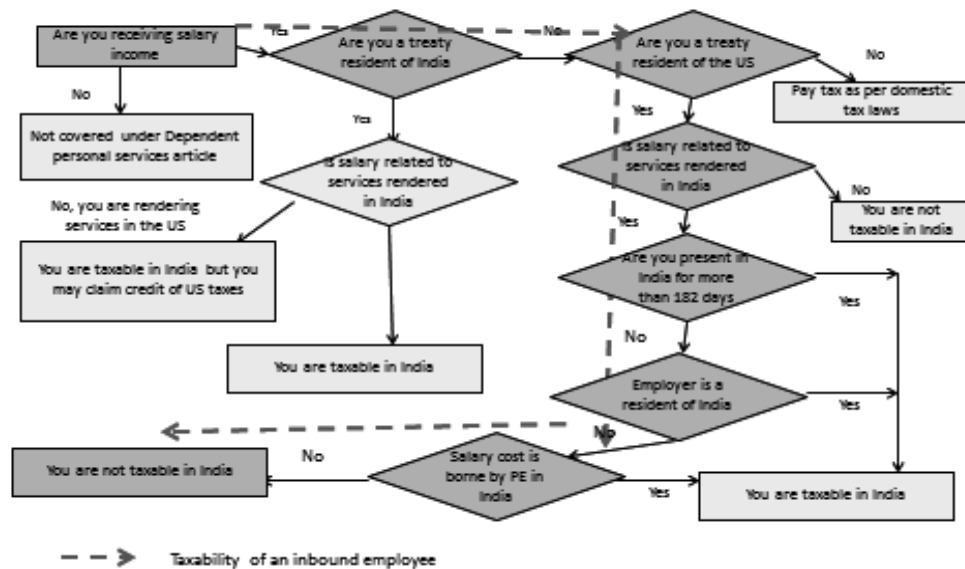
Expense is actually deducted when profits (and not gross receipts) are taxed on deemed basis. - Nakazono (2003) SOT 31(Del), Pride Foramer SA 2007 15 SOT 562 (Delhi)

If the expense is attributable to or deductible by PE, it should be considered as "borne by". whether deduction is actually claimed or not is irrelevant - Sedco Forex International Inc (2005)(147 Taxman 389)(Utt)

OECD'S BEPS Project

In July 2013 OECD released an Action Plan on addressing 'base erosion and profit shifting' (BEPS) which aims at curbing tax-avoidance strategies. OECD's Action Plan identifies 15 actions on BEPS, intending to carry out fundamental changes to the international tax standards. Action 6, one of the action points of the BEPS project, deals with treaty abuse and it categorically recognizes cases where a taxpayer inappropriately tries to obtain an exemption under Dependent Personal Service Article. It is noted that the OECD commentary on Article 15 (from para 8.1 to 8.28) endorses a substance over form approach and it would be sufficient to deal with such cases by ensuring that treaty benefits are not inappropriately availed. Further, BEPS Action 7 deals with 'preventing artificial avoidance of PE status' and it provides various proposals for changes in the definition of PE. The proposals are understood to lower the threshold of creating a PE and such proposals, if implemented in a Source State, may have an impact on DPS exemption condition of the PE test.

Mechanics of Article 16(2) – India US Tax Treaty



Infosys BPO Ltd. v. DCIT [2021]131 taxmann.com 293 (Bangalore – Trib)

Assessee-company was engaged in business of providing BPO services. During the year, assessee made payments towards legal service rendered to assessee by a law firm, a limited partnership in Poland. Law firm was a fiscally transparent entity which could not be taxed in its own right but its partners would be taxed on income received by partnership firm in accordance with article 15. Since partners were domiciled and subject to tax in Poland, impugned amount of fee paid by assessee for rendering legal advisory services was not taxable in India

16. Article 16 –Directors’ Fees

16.1 Scope of the Article

Article 16 of both OECD and UN model convention relates to the remuneration received by a person as a member of the board of directors of a company. “Person” herein referred to as means and includes an individual or a legal person who acts in the capacity of a member of the Board of Directors of a company. Further, the provision in this article treats the services of member of the board of directors as performed in the State of residence of the company.

Article 16 was introduced in the first OECD Model Treaty of 1963 and related to the remuneration received by a resident of a state, whether an individual or legal person, in the capacity of a member of a board of directors of a company which is a resident in the other contracting state. Before its introduction in the OECD Model, a separate treatment on directors’ fees could be found in article 6 of the 1927 Draft Convention of the League of Nations, which states: “*The fees of managers and directors of share companies shall be taxable in accordance with the rule laid down in Article 4.*” Article 4, which dealt with income from shares and similar interests, attributed

taxing rights to the country of the company's residence. The Commentary of the League of Nations Draft indicates that such a separate provision for income of company officers was needed to distinguish it from dividend income, since some domestic tax systems considered directors' fees to be company shares. The Commentary of the OECD Model clarifies that directors are treated under a separate article since it might be difficult to ascertain where the services are performed.

16.2 Article 16 in various model conventions

16.2.1 OECD Model Commentary [2014]

Text of the Article

ARTICLE 16

DIRECTORS' FEES

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

Most of the DTAAs signed by India contain the wordings as in the OECD model convention .

16.2.2 UN Model Convention [updated 2011]

Text of the Article

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVELMANAGERIAL OFFICIALS

1. Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.
2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Para 1 of the Article 16 in UN model convention is same as in the OECD model convention, however, para 2 is an additional para which contains the provision on payments in the form of salary, wages and other similar remuneration to a person at top-level managerial position of a company.

16.2.3 USA Model Convention [2006]

Text of the Article

Article 15

Directors' Fees

Directors' fees and other compensation derived by a resident of a Contracting State for services rendered in the other Contracting State in his capacity as a member of the board of directors of

a company that is a resident of the other Contracting State may be taxed in that other Contracting State.

Article on Directors' fees is numbered as Article 15 instead of Article 16 in the USA model Convention. USA Model convention has limited its scope in terms of that the primary right to tax vests in the state in which the company is resident, provided, however, that the services are also performed in that state.

16.3 Article 16 - Right to taxation

This article attributes in a non-exclusive way taxing rights over remunerations to the member of the board of directors of the company to the residence state of the company, which is also the source state in most cases. That state is entitled to tax such remunerations as prescribed by its domestic law without being restricted by the convention.

This article is non-exclusive, since the recipient's Residence state may also tax such remunerations. The latter State should however give relief for double taxation, but whether this should be done through an exemption of tax or through a credit for tax imposed by the source state, is to be determined by reference to Article on tax credit contained in the various treaties.

16.4 Scope of this Article vis-à-vis other Articles of the Model convention

Directors' fees should have ideally been taxed either under Article 14 or 15 of the model convention being income derived from an activity of an independent character or from an employment. However, due to specific Article 16, exclusion is carved out in Article 14 and 15 of the model tax convention for such type of income.

Article 14 dealing with independent personal services, was deleted from the OECD Model Convention in 2000 but is nevertheless still included in many double tax conventions. Article 14 gives exclusive taxing rights to the residence state of the person performing the independent personal service. Taxing rights are however attributed to the other contracting state on the condition that the person performing the service maintains a fixed base in that state from which he exercises his activities and to which the income can be ascribed. Thus, the attribution of taxing rights to the latter State depends on the physical presence of the person providing the independent personal services.

Article 15 dealing with income from employment establishes the general rule that such income is taxable in the State where the employment is actually exercised. This article also requires physical presence of the employee for the State other than his residence state to be entitled to tax his income.

Conclusively, if directors were to be taxed under any of these articles, taxing rights would be attributed to the State where director actually exercises his/her activities as a member of the board. However, Article 16 contains a special provision that deviates from this in a way that it does not require physical presence of the director in the Residence state of the company in which he/she performs his activities for the latter State to be entitled to tax the remunerations he/she receives.

Hence, Article 16 can be seen as overriding a general rule in articles 14 and 15.

16.5 Article 16 of the OECD and UN Model – Commentary and Interpretation

Since para 1 of the UN model convention is same as OECD model convention, commentary of OECD model convention is referred in substance by the UN Model Convention.

16.5.1 Company's residence key to taxing directors' fees

Agreeing on the principles of Article 14 and 15 whereby primary right to tax income is to the state where services are performed, it is acknowledged by the OECD and UN model commentary that since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.

Also, the attribution of taxing rights by article 16 to residence state of company (ie source state) seems to be based on the concern that the tax base in the source state is eroded due to the deduction of the directors' fees. So by charging tax on directors' fees in the source state, problem of base erosion is avoided.

In some countries organs of companies exist which are similar in function to the board of directors. Contracting States are free to include in bilateral conventions such organs of companies under a provision corresponding to Article 16.

16.5.2 The Term – 'Directors'

A director is an officer charged with the conduct and management of the affairs of the company. The directors collectively are referred to as Board of Directors.

Typical duties of boards of directors include:

- governing the organization by establishing broad policies and objectives;
- selecting, appointing, supporting and reviewing the performance of the chief executive;
- ensuring the availability of adequate financial resources;
- approving annual budgets;
- accounting to the stakeholders for the organization's performance;
- setting the salaries and compensation of company management

The legal responsibilities of boards and board members vary with the nature of the organization, and with the jurisdiction within which it operates.

For the purpose of this Article, it is important to note that it is not sufficient if a person performs similar functions as a director. He must necessarily be an official member of the Board of Directors.

16.5.3 What all is covered under Directors' fees / remuneration

Member countries have generally understood the term "fees and other similar payments" to also

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include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).

The term 'directors' fees and other similar payments means remuneration paid in connection with the supervision of the Company's management to a person who is a member of the Board of Directors.

Article 16 of the UN Model Convention also includes a second paragraph not in the OECD Model Convention, dealing with remuneration received by top-level managerial officials.

Members of the UN decided that where a top-level managerial position of a company resident in a Contracting State is occupied by a resident of the other Contracting State, the remuneration paid to that official should be subject to the same principle as directors' fees.

The term "top-level managerial position" refers to a limited group of positions that involve primary responsibility for the general direction of the affairs of the company, apart from the activities of the directors. The term covers a person acting as both a director and a top-level manager.

India tax treaty with Denmark, Korea, Norway and Poland covers both director fees and top level managerial remuneration. Tax treaty with UK and USA only covers directors' fees.

Member of the board of directors of a company often also has other functions with the company, e.g. as ordinary employee, adviser, consultant, etc. It is clear that the Article does not apply to remuneration paid to such a person on account of such other functions. [This position does not apply under the United Nations Model Convention to the extent that paragraph 2 of Article 16 applies.] Therefore, the word 'fees' indicates that this Article is not intended to include normal remuneration received by the manager or executive director for his managerial functions. The reasoning behind this is that unlike executive directors, in case of other directors, the role is not envisaged to be a full time occupation.

In many countries, company law permits directors to act in more than one capacity as in an employee or a consultant and as well as member of board of directors. In such a situation, if segregation of the remuneration is possible vis-à-vis his/her responsibilities, then such remunerations can be attributed and taxed in respective Articles. If this segregation is not possible, the primary function will be at best be considered as having dominance over others and remuneration accordingly treated under the respective Article. Similar view has been upheld in *Dieter Eberhard Gustav Von Der Mark vs CIT* in 235 ITR 698 [AAR] wherein it was held that only sitting fee would be taxable and other fees without a fixed base would not be taxable under Article 16 of the India – Germany DTAA..

To summarize, following payments are covered under this Article

- (i) directors fees and other similar payments and also includes remuneration paid in connection with the supervision of company's management,
- (ii) directors commission,

- (iii) benefits in kind like:
 - (a) use of automobile and residence
 - (b) vehicle insurance
 - (c) insurance coverage
 - (d) club membership
 - (e) stock options
- (iv) Salaries, wages and other similar remuneration paid to top-level managerial position under UN Model Convention

To summarize, following payments are not covered under this Article

- (i) consultancy fees received for rendering professional services
- (ii) that remuneration received by Directors' in other capacity such as consultants, employees, advisors, etc.
- (iii) manager not being a director is not covered
- (iv) disguised profit distributions by a company to ex-Chairman
- (v) fees received in the capacity of a member of certain committees

16.5.4 Stock options

Many of the issues discussed under paragraphs 12 to 12.15 of the Commentary on Article 15 in relation to stock-options granted to employees will also arise in the case of stock-options granted to members of the board of directors of companies.

To the extent that stock-options are granted to a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other State, that other State will have the right to tax the part of the stock-option benefit that constitutes director's fees or a similar payment even if the tax is levied at a later time when the person is no longer a member of that board.

While the Article applies to the benefit derived from a stock-option granted to a member of the board of directors regardless of when that benefit is taxed, there is a need to distinguish that benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the company or issuer). Once the option is exercised or alienated, however, the benefit taxable under this Article has been realised and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the member of the board of directors in his capacity of investor-shareholder and will be covered by Article 13.

Indeed, it is at the time of exercise that the option, which is what the director obtained in his capacity as such, disappears and the recipient obtains the status of shareholder (and usually

invests money in order to do so).

17. Article 17 – Artistes and Sportsperson

17.1 Scope of the Article

The taxation of international artistes and sportsmen is a small but special topic in international taxation. The field of taxation of artistes and sportsperson has attracted global attention given the increasing spate of international stage shows, global concert tours, goliath international sporting events and the enormous revenues involved. Also, artistes and sportsmen enjoy high mobility, high and diverse remuneration and that their income is often earned in many countries, in addition to their country of residence.

Most states in the world follow Article 17 of the OECD Model Tax Convention (hereinafter 'OECD Model'), which means that they levy a withholding tax on the performance fees of non-resident artistes and sportsmen, even if they are self-employed, their fees are business income, and they do not have a permanent establishment in the state of performance. The OECD believes that this taxation at source, deviating from Article 7 (business income) and Article 15 (employment income), is a reasonable measure to ensure that every artiste and sportsman pays his share of his earnings to the government. Due to the fact that Article 17 has been taken over in the UN Model Tax Convention, not only the OECD Member States but also many other states follow this instruction, both in their tax treaties and in their national legislation

17.2 Article 17 in various model convention

17.2.1 OECD Model Commentary [2014]

Text of the Article

ARTICLE 17

ENTERTAINERS AND SPORTSPERSONS

1. *Notwithstanding the provisions of Article 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from that resident's personal activities as such exercised in the other Contracting State, may be taxed in that other State.*
2. *Where income in respect of personal activities exercised by an entertainer or a sportsperson acting as such accrues not to the entertainer or sportsperson but to another person, that income may, notwithstanding the provisions of Article 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.*

This exceptional clause for artistes and sportsmen was introduced as Article 17 in the 1963 OECD Model, with the argument that 'practical difficulties are avoided which often arise in taxing public entertainers and athletes performing abroad'.

In 1977, the OECD introduced a second paragraph to Article 17, under which also payments to

others than the artistes and sportsmen would fall. With Article 17(2), the OECD intended 'to counteract tax avoidance devices in cases where remuneration for the performance of an entertainer or athlete is not paid to the entertainer or athlete himself but to another person, for example, a so-called artiste company'.

In 1987, an OECD Report about artistes and sportsmen brought forward that Article 17 was meant to 'counteract tax avoidance behaviour and non-compliance'. Where in 1977 the OECD preferred the limited approach for Article 17(2), that is, only for so-called star companies, the 1987 OECD Report changed this into the unlimited approach, allocating the taxing right to the state of performance for any payment for artistic or sports performances to any third party.

17.2.2 UN Model Convention [updated 2011]

Text of the Article 17

ARTISTES AND SPORTSPERSONS

1. *Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.*
2. *Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.*

Article 17 of the United Nations Model Convention reproduces Article 17 of the OECD Model with one modification. Instead of the word "sportsman" used in the OECD Model Convention (in place of "athlete" earlier used in both the United Nations and OECD Model Conventions), it has been decided to use the gender neutral word "sportsperson".

17.2.3 USA Model Convention [2006]

Text of the Article

Article 16

Entertainers and Sportsmen

1. *Income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, which income would be exempt from tax in that other Contracting State under the provisions of Articles 7 (Business Profits) and 14 (Income from Employment) may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or sportsman, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars (\$20,000) or its equivalent in -----*

for the taxable year of the payment.

2. *Where income in respect of activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income, notwithstanding the provisions of Article 7 (Business Profits) or 14 (Income from Employment), may be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised unless the contract pursuant to which the personal activities are performed allows that other person to designate the individual who is to perform the personal activities.*

The model tax convention used by the United States limits the application of article 17 to cases where the athlete's salary derived from the country of performance exceeds a certain amount. For practical reasons, where the payments do not exceed the established "level of triviality", the source state waives its right to tax.

As regards the provision of article 16(2), when the income accrues to a person other than the performer, the income may be taxed in the Contracting State where the performer's services are exercised, without regard to the provisions of the Convention concerning business profits (Article 7) or income from employment (Article 14), unless the contract pursuant to which the personal activities are performed allows the person other than the performer to designate the individual who is to perform the personal activities.

The premise of this rule is that, in a case where a performer is using another person in an attempt to circumvent the provisions of paragraph 1, the recipient of the services of the performer would contract with a person other than that performer (i.e., a company employing the performer) only if the recipient of the services were certain that the performer himself would perform the services. If instead the person is allowed to designate the individual who is to perform the services, then likely the person is a service company not formed to circumvent the provisions of paragraph 1. The following example illustrates the operation of this rule.

Example - Company O, a resident of the other Contracting State, is engaged in the business of operating an orchestra. Company O enters into a contract with Company A pursuant to which Company O agrees to carry out two performances in the United States in consideration of which Company A will pay Company O \$200,000. The contract designates two individuals, a conductor and a flutist, that must perform as part of the orchestra, and allows Company O to designate the other members of the orchestra. Because the contract does not give Company O any discretion to determine whether the conductor or the flutist perform personal services under the contract, the portion of the \$200,000 which is attributable to the personal services of the conductor and the flutist may be taxed by the United States pursuant to paragraph 2. The remaining portion of the \$200,000, which is attributable to the personal services of performers that Company O may designate, is not subject to tax by the United States pursuant to paragraph 2.

17.3 Article 17 - Scope of taxation

As per the OECD Model, this article attributes non-exclusive taxing rights to the source state where the income is generated by performing the described activities of the artistes and

sportsperson, whether these performances are of an independent or of a dependent nature.

As per the US Model Convention, the 'controlling factor' in determining whether the income falls under the Article 17(1) or another Article is to ascertain whether the income in question is predominantly attributable to the performer itself or other activities or property rights. If so, said income would be covered in the ambit of Article 17(1) and the source country would have the right to tax it.

An individual may both direct a show and act in it, or may direct and produce a television programme or film and take a role in it. In such cases it is necessary to look at what the individual actually does in the State where the performance takes place. If his activities in that State are predominantly of a performing nature, the Article will apply to all the resulting income he derives in that State. If, however, the performing element is a negligible part of what he does in that State, the whole of the income will fall outside the Article. In other cases an apportionment should be necessary.

The article makes it clear that the general rule for business income from Article 7 does not apply to artistes. This means that the source country has the right to tax the performance income when the artistes are self-employed, even if their fees are business income and they do not have a permanent establishment in the country of performance.

Nor does the general rule for income from employment from Article 15 apply to artistes. This means that artistes who are employees may also be taxed in the country of their performance, even if they are employed and paid by a company in their residence country and travel abroad only for short-term performances.

It should be noted that Article 17 of the OECD Model allows the source state to impose a tax according to its domestic law, without any limitations. There is no guidance in Article 17 of the OECD Model regarding the tax base, tax rate and form of collecting tax. Moreover, there are no strict rules on the deduction of expenses. All of these important elements are left to the source country's domestic tax law.

The wording of Article 17 leaves open the question of taxation of income from artistic and sporting activities in the state of residence. It is an open distributive rule which indicates that income "may" be taxed in the source state, omitting "only". Thus, the primary taxation right is left to the state of source but the residence state also formally retains the taxing right. If the state of residence levies tax on such income under domestic law, it depends on Article 23A or B of the OECD Model whether it must grant an exemption or allow credit for the tax paid to the source state. If the residence state exempts the income, either under its domestic law or pursuant to a tax treaty, double non-taxation may occur when the source state grants certain tax exemptions to entertainers or sportsmen. Generally, taxation in the residence state is preserved in such situations through the application of the tax credit method or through a subject-to-tax clause.

As per OECD Members, this provision makes it possible to avoid the practical difficulties which often arise in taxing artistes and sportsmen performing abroad.

However, OECD has acknowledged that too strict provisions as provided in Article 17 might in certain cases impede cultural exchanges and in order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to independent activities. To achieve this it would be sufficient to amend the text of the Article so that an exception is made only to the provisions of Article 14. In such a case, artistes and sportsmen performing in the course of an employment would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article.

17.4 Article 17 of the OECD and UN Model – Commentary and Interpretation

Since article 17 of the UN model convention is same as OECD model convention, commentary of OECD model convention is referred in substance by the UN Model Convention.

17.4.1 Meaning of ‘artistes’, ‘entertainer’ and ‘sportsperson’

The word “artiste” is mentioned in the title of Article 17 of the OECD Model and the word “entertainer” is used in the text of the article, but then again the word “artiste” is linked to the examples that are given in the text. With the wording in the title (“artiste”) and the text (“an entertainer, such as a ... artiste”), Article 17 of the OECD Model seems to assume a strong connection and partial equivalence between these two words. Therefore, both words need a good explanation, although the word “artiste” seems to have a predominant position.

OECD has specifically stated in its commentary that it is not possible to give a precise definition of "artiste", but paragraph 1 includes examples of persons who would be regarded as such. These examples should not be considered as exhaustive. On the one hand, the term "artiste" clearly includes the stage performer, film actor, actor (including for instance a former sportsman) in a television commercial. The Article may also apply to income received from activities which involve a political, social, religious or charitable nature, if an entertainment character is present. On the other hand, it does not extend to a visiting conference speaker or to administrative or support staff (e.g. cameramen for a film, producers, film directors, choreographers, technical staff, road crew for a pop group etc.). In between there is a grey area where it is necessary to review the overall balance of the activities of the person concerned.

Whilst no precise definition is given of the term "sportsmen", it is not restricted to participants in traditional athletic events (e.g. runners, jumpers, swimmers). It also covers, for example, golfers, jockeys, footballers, cricketers and tennis players, as well as racing drivers.

One will note that neither the Article nor the Commentary considers professional models. Many “super-models” have reputations at least as great as the designers whose clothes (or other fashion accessories) adorn them. It is certainly open to doubt whether models participating in photo-shoots could be considered entertainers, as that term is used in Article 17. The issue becomes more clouded where the model participates in a fashion show or a commercial. It is unlikely that a fashion show could be considered theatre, although it may be considered a form of entertainment for spectators, many of whom may attend as much to see the models as to see the clothes they wear. Where a model appears in a commercial, they may be considered to be

acting.

Author Dick Molenaar in his thesis – Taxation of International Performing Artistes (part of IBFD Doctorial Series) has mentioned that based on the survey of the literature available on the term ‘artiste’ in various countries, following can be concluded:

17.4.2 General definition

“An artiste is a person giving an artistic and entertaining performance directly or indirectly before an audience, regardless of the artistic or entertainment level.”

This definition implies that:

- there must be a performance;
- the performance is in public, i.e. directly before an audience or recorded and later reproduced for an audience; and
- the predominant element of the performance must be artistic and entertaining, but the level is irrelevant.

With this definition it is possible to make two lists of persons, “artistes” and “non-artistes”:

Artistes	Non-artistes
acrobats	actors, musicians, etc. in commercials
actors (theatre, television, radio)	Anchor men (radio, television)
circus artistes	architects
comedians	auctioneers
conductors	authors
disc jockeys (DJs)	booking agents
fakirs	cameramen
magicians	choreographers
masters of ceremony (MCs)	composers
musicians	crew (film, television, radio, live show)
packaging artists (e.g. Christo)	cutters
puppet theatre players	dead artistes (entitled to part of performance fee)
quizmasters and participants	designers (stage, light, fashion)
radio play actors	directors (theatre, television, radio)
ring masters in circus	discoverers
sex performers (peep- and live shows)	engineers (sound, light, video)
Singers	fashion designers

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Artistes	Non-artistes
TV and radio “artistes”	funeral orators
video jockeys (VJs)	impresarios
writers reading from their work	interviewers (television, radio, live)
	interview guests (idem)
	inventors
	journalists
	managers
	models in commercials
	models in fashion shows
	painters
	photographers
	piano tuners
	politicians
	producers
	radio personalities (e.g. disc jockeys, news readers)
	rehearsals by any artiste, conductor, etc.
	reporters
	restaurateurs
	sculptors
	sound technicians
	speakers at conferences
	stage builders
	teachers of music, theatre, dance, etc.
	technical personnel
	TV and radio personalities (e.g. anchor personnel, weather persons, talk show hosts)
	tour accountants
	tour managers
	writers

Umpires and match referee renders professional or technical services and cannot be regarded

as sports person (including athlete) - Indcom v. CIT [2011] 11 Taxman.com 109 (Cal)

Players of cricket associations of the countries participating in the World Cup would be 'entertainers' for the purpose of Article 17 of the DTAA – *PILCOM [2001](77 ITD 218)(Cal ITAT)*

The Indian Courts have interpreted the meaning of the term 'artiste' in relation to erstwhile provisions of Section 80RR of the Act in following cases which can be used to understand meaning of 'Artiste' in Indian context:

Decision	Citation	Nature of profession considered as Artiste
Harsha Bhogle	86 ITD 714 (Mumbai Tribunal)	Income as cricket Commentator and show presenter is not an income of artist
Aishwarya Rai	ITA Nos. 1062 & 816/Mum/2007 vide its order dated 07-09-2009 (Mumbai Tribunal)	Brand Ambassador fees is an income of artiste
Tarun Tahiliani	Income-tax Appeal (L) Nos.922 and 1275 Of 2009 dated 14 June 2010	Fashion Designer income is an income of artiste
Sachin Tendulkar	ITA Nos.428 to 430/Mum/2008 and ITA No. 6862/Mum/2008 dated 20 May 2011	Income from modelling and appearing in T.V. commercials is an income of artiste
Amitabh Bachchan	12 SOT 95	Income from anchor of TV show is an income of artiste
Shahrukh Khan	ITA No.3894/Mum/2000 and other appeals vide order dated 19.6.2008	Brand endorsement and modelling income is an income of artiste

Further, Bombay High Court in case of Wizcraft International Entertainment Ltd (2014) 364 ITR 227 (Bom) has also dealt with taxability of income of the artist in India in view of article 18(2) under India – UK DTAA.

17.4.3 Types of incomes covered

As per the plain reading of the paragraph 1 of Article 17 of the OECD Model, any financial reward or remuneration for the actual performance of an artiste/sportsperson will fall under Article 17; the taxing right will be allocated to the country where the performance takes place.

The paragraph applies regardless of who pays the income. For example, it covers prizes and awards paid by a national federation, association or league which a team or an individual may receive in relation to a particular sports event.

The Article also applies to income from other activities which are usually regarded as of an entertainment character, such as those deriving from billiards and snooker, chess and bridge tournaments.

Income received by impresarios, etc. for arranging the appearance of an artiste or sportsman is outside the scope of the Article, but any income they receive on behalf of the artiste or sportsman is of course covered by it.

Paragraph 1 applies to income derived directly and indirectly by an individual artiste or sportsman. In some cases the income will not be paid directly to the individual or his impresario or agent. For instance, a member of an orchestra may be paid a salary rather than receive payment for each separate performance: a Contracting State where a performance takes place is entitled, under paragraph 1, to tax the proportion of the musician's salary which corresponds to such a performance. Similarly, where an artiste or sportsman is employed by e.g. a one person company, the State where the performance takes place may tax an appropriate proportion of any remuneration paid to the individual. In addition, where its domestic laws "look through" such entities and treat the income as accruing directly to the individual, paragraph 1 enables that State to tax income derived from appearances in its territory and accruing in the entity for the individual's benefit, even if the income is not actually paid as remuneration to the individual.

Besides fees for their actual performances, entertainers and sportspersons often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there is no close connection between the income and the performance of activities in the country concerned. Such a close connection will generally be found to exist where it cannot reasonably be considered that the income would have been derived in the absence of the performance of these activities. This connection may be related to the timing of the income-generating event (e.g. a payment received by a professional golfer for an interview given during a tournament in which she participates) or to the nature of the consideration for the payment of the income (e.g. a payment made to a star tennis player for the use of his picture on posters advertising a tournament in which he will participate).

Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (see paragraph 18 of the Commentary on Article 12), but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which has a close connection with a performance in a given State (e.g. payments made to a tennis player for wearing a sponsor's logo, trade mark or trade name on his tennis shirt during a match). Such a close connection may be evident from contractual arrangements which relate to participation in named events or a number of unspecified events; in the latter case, a Contracting State in which one or more of these events take place may tax a proportion of the relevant advertising or sponsorship income (as it would do, for example, in the case of remuneration covering a number of unspecified performances;). Similar income which could not be attributed to such performances would fall under the standard rules of Article 7 or Article 15, as appropriate. Various payments may be made as regards merchandising; whilst the payment to an entertainer or sportsperson of a share of the merchandising income

closely connected with a public performance but not constituting royalties would normally fall under Article 17, merchandising payments derived from sales in a country that are not closely connected with performances in that country and that do not constitute royalties would normally be covered by Article 7 (or Article 15, in the case of an employee receiving such income).

1. When a performance contract is terminated by the organizer, the artiste can receive a compensation payment for not being allowed to perform. Both the 1987 OECD Report and the OECD Commentary state that a cancellation fee does not fall under Article 17. This opinion is understandable because no entertainment or artistic activity takes place in the source country. The 1987 OECD Report considers Article 21 of the OECD Model applicable, while the Commentary refers to Articles 7 and 15 of the OECD Model. Both lead to the same result, because the conditions for taxation in the source country, namely a permanent establishment (Article 7) or exercise of employment (Article 15) in the source country are not fulfilled. A cancellation fee will therefore solely be taxed in the country of residence of the artiste.

Cancellation of the performance can also be initiated by the artiste, if he is unable to perform because of health problems or for any other reason. The organizer will not be obliged to pay a fee, so the artiste can try to cover this risk with an insurance contract. This will have the same effect as a cancellation fee, i.e. there will be no taxing right in the performance country because no performance has taken place.

2. Guarantee fees paid by the BCCI to the cricket boards of overseas countries while the overseas cricketers are on a tour of India, is liable to tax in India under this article. (BCCI v. DIT [2005] 96 ITD 263 (Mum. Trib.))

3. Apart from the above examples, there are a number of cases where it may be difficult to determine whether a particular item of income is derived by a person as an entertainer or sportsperson from that person's personal activities as such. The following principles may be useful to deal with such cases:

The reference to an "entertainer or sportsperson" includes anyone who acts as such, even for a single event. Thus, Article 17 can apply to an amateur who wins a monetary sports prize or a person who is not an actor but who gets a fee for a once-in-a-lifetime appearance in a television commercial or movie.

- As noted in the previous paragraphs, the activities of an entertainer or sportsperson do not include only the appearance in an entertainment or sports event in a given State but also, for example, advertising or interviews in that State that are closely connected with such an appearance.
- Merely reporting or commenting on an entertainment or sports event in which the reporter does not himself participate is not an activity of an entertainer or sportsperson acting as such. Thus, for instance, the fee that a former or injured sportsperson would earn for offering comments during the broadcast of a sports event in which that person does not participate would not be covered by Article 17.
- Preparation, such as rehearsal and training, is part of the normal activities of entertainers

and sportspersons. If an entertainer or sportsperson is remunerated for time spent on rehearsal, training or similar preparation in a State (which would be fairly common for employed entertainers and sportspersons but could also happen for a self-employed individual, such as an opera singer whose contract would require participation in a certain number of rehearsals), the relevant remuneration, as well as remuneration for time spent travelling in that State for the purposes of performances, rehearsal and training (or similar preparation), would be covered by the Article. This would apply regardless of whether or not such rehearsal, training or similar preparation is related to specific public performances taking place in that State (e.g. remuneration that would be paid with respect to the participation in a pre-season training camp would be covered).

- Payments for the simultaneous broadcasting of a performance by an entertainer or sportsperson made directly to the performer or for his or her benefit (e.g. a payment made to the star-company of the performer) fall within the scope of Article 17 (see paragraph 18 of the Commentary on Article 12, which also deals with payments for the subsequent sales or public playing of recordings of the performance). Where, however, the payment is made to a third party (e.g. the owner of the broadcasting rights) and that payment does not benefit the performer, the payment is not related to the personal activities of the performer and therefore does not constitute income derived by a person as an entertainer or sportsperson from that person's personal activities as such. For example, where the organiser of a football tournament holds all intellectual property rights in the event and, as such, receives payments for broadcasting rights related to the event, Article 17 does not apply to these payments; similarly, Article 17 will not apply to any share of these payments that will be distributed to the participating teams and will not be re-distributed to the players and that is not otherwise paid for the benefit of the players. Whether such payments will constitute royalties covered by Article 12 will depend, among other things, on the legal nature of such broadcasting rights, in particular under the relevant copyright law.
- It is frequent for entertainers and sportspersons to derive, directly or indirectly (e.g. through a payment made to the star-company of the entertainer or sportsperson), a substantial part of their income in the form of payments for the use of, or the right to use, their "image rights", e.g. the use of their name, signature or personal image. Where such uses of the entertainer's or sportsperson's image rights are not closely connected with the entertainer's or sportsperson's performance in a given State, the relevant payments would generally not be covered by Article 17 (see paragraph 9 above). There are cases, however, where payments made to an entertainer or sportsperson who is a resident of a Contracting State, or to another person, for the use of, or right to use, that entertainer's or sportsperson's image rights constitute in substance remuneration for activities of the entertainer or sportsperson that are covered by Article 17 and that take place in the other Contracting State. In such cases, the provisions of paragraph 1 or 2, depending on the circumstances, will be applicable.

Entertainers and sportspersons often perform their activities in different States making it necessary to determine which part of their income is derived from activities exercised in each State. Whilst such determination must be based on the facts and circumstances of each case, the following general principles will be relevant for that purpose:

- An element of income that is closely connected with specific activities exercised by the entertainer or sportsperson in a State (e.g. a prize paid to the winner of a sports competition taking place in that State; a daily allowance paid with respect to participation in a tournament or training stage taking place in that State; a payment made to a musician for a concert given in a State) will be considered to be derived from the activities exercised in that State.
- As indicated in paragraph 1 of the Commentary on Article 15, employment is exercised where the employee is physically present when performing the activities for which the employment remuneration is paid. Where the remuneration received by an entertainer or sportsperson employed by a team, troupe or orchestra covers various activities to be performed during a period of time (e.g. an annual salary covering various activities such as training or rehearsing; travelling with the team, troupe or orchestra; participating in a match or public performance, etc.), it will therefore be appropriate, in the absence of any indication that the remuneration or part thereof should be allocated differently, to allocate that salary or remuneration on the basis of the working days spent in each State in which the entertainer or sportsperson has been required, under his or her employment contract, to perform these activities.

The following examples illustrate these principles:

- Example 1: A self-employed singer is paid a fixed amount for a number of concerts to be performed in different states plus 5 per cent of the ticket sales for each concert. In that case, it would be appropriate to allocate the fixed amount on the basis of the number of concerts performed in each State but to allocate the payments based on ticket sales on the basis of where the concerts that generated each such payment took place.
- Example 2: A cyclist is employed by a team. Under his employment contract, he is required to travel with the team, appear in some public press conferences organised by the team and participate in training activities and races that take place in different countries. He is paid a fixed annual salary plus bonuses based on his results in particular races. In that case, it would be reasonable to allocate the salary on the basis of the number of working days during which he is present in each State where his employment-related activities (e.g. travel, training, races, and public appearances) are performed and to allocate the bonuses to where the relevant races took place.

17.4.4 Mechanism for computing Income

The Article says nothing about how the income in question is to be computed. It is for a Contracting State's domestic law to determine the extent of any deductions for expenses. Domestic laws differ in this area, and some provide for taxation at source, at a low rate based on the gross amount paid to artistes and sportsmen. Such rules may also apply to income paid

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to groups or incorporated teams, troupes, etc. Some States, however, may consider that the taxation of the gross amount may be inappropriate in some circumstances even if the applicable rate is low. These States may want to give the option to the taxpayer to be taxed on a net basis. This could be done through the inclusion of a paragraph drafted along the following lines:

Where a resident of a Contracting States derives income referred to in paragraph 1 or 2 and such income is taxable in the other Contracting States on a gross basis, that person may, within [period to be determined by the Contracting States] request the other State in writing that the income be taxable on a net basis in that other State. Such request shall be allowed by that other State. In determining the taxable income of such resident in the other State, there shall be allowed as deductions those expenses deductible under the domestic laws of the other State which are incurred for the purposes of the activities exercised in the other State and which are available to a resident of the other State exercising the same or similar activities under the same or similar conditions.

Some States may also consider that it would be inappropriate to apply Article 17 to a non-resident entertainer or sportsperson who would not otherwise be taxable in a Contracting State (e.g. under the provisions of Article 7 or 15) and who, during a given taxation year, derives only low amounts of income from activities performed in that State. States wishing to exclude such situations from the application of Article 17 may do so by using an alternative version of paragraph 1 drafted along the following lines:

Notwithstanding the provisions of Article 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the gross amount of such income derived by that resident from these activities exercised during a taxation year of the other Contracting State does not exceed an amount equivalent to [_____] expressed in the currency of that other State at the beginning of that taxation year or any other amount agreed to by the competent authorities before, and with respect to, that taxation year.

In terms of section 115BBA of the Act, a tax rate of 20% applies to the gross income arising to:

- (i) A non-resident sportsman (including athlete) who is not a citizen of India and who earns income from:
 - Participation in India in any game (other than lotteries, crossword puzzles, races, card games, gambling or betting of any form) or sport
 - Advertisement
 - Contribution of articles relating to any game or sport in India in newspapers, magazines or journals
- (ii) A non-resident sports association or institution that earns guarantee money in relation to any game (other than lotteries, crossword puzzles, races, card games, gambling or

betting of any form) or sport played in India

- (iii) A non-resident entertainer who is not a citizen of India and who earns income from his performance in India.

The Central Board of Direct taxes has issued Circular 787 dated 10 February 2000 that deals with certain issues on taxation aspect concerning national and international events and shows for entertainment, sports in India. The Circular provides that income of a sportsman participating in an event in India would be liable to tax in India. The relevant extracts of circular are as under:

“3. In the case of non-residents, in addition to the provisions of the Income-tax Act, 1961, the applicability of Double Taxation Avoidance Agreement (DTAA) should be examined. The Income-tax Act, 1961 provides that in case of sportsmen or artists participating in such events or shows, all income accruing or arising or deemed to be accruing or arising, received or deemed to be received in India is taxable in India.”

The Circular further guides that:

- Receipts from events or shows for entertainment, sports, etc. may include:
 - Sponsorship money
 - Gate money
 - Advertisement revenue
 - Sale of broadcasting or telecasting rights
 - Rents from hiring out of space, etc.
 - Rents from caterers
- DTAA Article on ‘Artistes and Sportsmen’ will apply to:
 - Income from personal activities of sportsman or artist in India, which accrues to such sportsman/artist or to another person
 - Advertising income
 - Sponsorship income, if it is related directly or indirectly to performance or appearance in India
- DTAA Article on ‘Royalty’ will apply to royalty payment for recorded performance
- DTAA Article on ‘Other Income’ will apply to guarantee money arising to foreign sports association
- Examples of income not taxable in India:
 - Performance in India gratuitously without consideration
 - Performance in India for no consideration, to promote sale of records
 - Consideration paid to acquire the copyrights of performance in India for subsequent, sale, broadcast or telecast abroad

- Examples of income taxable in India:
 - Consideration for live performance or simultaneous live telecast or broadcast in India
 - Consideration paid to acquire the copyrights of performance in India for subsequent, sale, broadcast or telecast in India
 - Endorsement fee (for launch or promotion of products, etc.) that relates to the performance in India

17.4.5 Provisions of Article 17(2) – Anti-avoidance Rules

Paragraph 2 of OECD and UN Models deals with situations where income from their activities accrues to other persons. If the income of an entertainer or sportsman accrues to another person, and the State of source does not have the statutory right to look through the person receiving the income to tax it as income of the performer, paragraph 2 provides that the portion of the income which cannot be taxed in the hands of the performer may be taxed in the hands of the person receiving the remuneration. If the person receiving the income carries on business activities, tax may be applied by the source country even if the income is not attributable to a permanent establishment there. If the person receiving the income is an individual, the income may be taxed even in the absence of a fixed base. But it will not always be so. There are three main situations of this kind:

- (a) The first is the management company which receives income for the appearance of, e.g. a group of sportsmen (which is not itself constituted as a legal entity).
- (b) The second is the team, troupe, orchestra, etc. which is constituted as a legal entity. Income for performances may be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the State in which a performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance; however, if the members are paid a fixed periodic remuneration and it would be difficult to allocate a portion of that income to particular performances, member countries may decide, unilaterally or bilaterally, not to tax it. The profit element accruing from a performance to the legal entity would be liable to tax under paragraph 2.
- (c) The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g. a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits it to impose a tax on the profits diverted from the income of the artiste or sportsman to the enterprise. It may be, however, that the domestic laws of some States

do not enable them to apply such a provision. Such States are free to agree to other solutions or to leave paragraph 2 out of their bilateral conventions.

The application of paragraph 2 is not restricted to situations where both the entertainer or sportsman and the other person, to whom the income accrues, e.g. a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, e.g. a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws.

Paragraph 2 does not apply, however, to prize money that the owner of a horse or the team to which a race car belongs derives from the results of the horse or car during a race or during races taking place during a certain period. In such a case, the prize money is not paid in consideration for the personal activities of the jockey or race car driver but in consideration for the activities related to the ownership and training of the horse or the design, construction, ownership and maintenance of the car. Such prize money is not derived from the personal activities of the jockey or race car driver and is not covered by Article 17. Clearly, however, if the owner or team receives a payment in consideration for the personal activities of the jockey or race car driver, that income may be taxed in the hands of the jockey or race car driver under paragraph 1.

Paragraph 2 covers income that may be considered to be derived in respect of the personal activities of an entertainer or sportsperson. Whilst that covers income that is received by an enterprise that is paid for performing such activities (such as a sports team or orchestra), it clearly does not cover the income of all enterprises that are involved in the production of entertainment or sports events. For example, the income derived by the independent promoter of a concert from the sale of tickets and allocation of advertising space is not covered by paragraph 2.

As a general rule it should be noted, however, that, regardless of Article 17, the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsman or the star-company in abusive cases, as is recognised in paragraph 24 of the Commentary on Article 1.

US have expressed reservations on this unlimited approach adopted by the OECD Model. As per commentary to US Model, Article 17(2) should not affect the legitimate employee-employer relationship between the performer and the persons providing his services. It further states that Article 17(2) should not apply if it is established that neither the performer nor any persons related to the performer, participates directly or indirectly in the receipts or profits of the person

providing performers' services. As per commentary to US Model, the provisions of Article 17(2) should be read only to prevent abuse of the source country's tax system by such fancy structures.

Whilst the Article does not provide how the income covered by paragraphs 1 and 2 is to be computed and leaves it to the domestic law of a Contracting State to determine the extent of any deductions, the income derived in respect of the personal activities of a sportsperson or entertainer should not be taxed twice through the application of these two paragraphs. This will be an important consideration where, for example, paragraph 2 allows a Contracting State to tax the star-company of an entertainer on a payment received by that company with respect to activities performed by the entertainer in that State and paragraph 1 also allows that State to tax the part of the remuneration paid by that company to the entertainer that can reasonably be attributed to these activities. In that case, the Contracting State may, depending on its domestic law, either tax only the company or the entertainer on the whole income attributable to these activities or tax each of them on part of the income, e.g. by taxing the income received by the company but allowing a deduction for the relevant part of the remuneration paid to the entertainer and taxing that part in the hands of the entertainer.

The Mumbai tribunal in the case of *Wizcraft International Entertainment Private Limited vs ADIT* held that (a) agency commission / remuneration; and (b) reimbursement of travel and other expenditure of artistes paid to a non-resident agent are not covered in the provisions of Article 18(2) of the India – UK tax treaty. In this case, Wizcraft, an Indian company, had entered into agency agreement with a non-resident to deal with artistes. Wizcraft deducted taxes on amounts paid to such artistes under the Article 18(1) of the India-UK tax treaty, while no taxes were withheld on the agency commission and reimbursements.

The ITAT observed that it was customary and necessary as part of regular industry practice for Wizcraft, the Indian company, to deal with such artistes through agents; and the non-resident agent so appointed was their own agent and not artistes' agent. It observed that the non-resident agent would hence be liable to tax as per the normal provisions of India-UK tax treaty.

17.4.6 Provisions of Article 17(3) – Exception to Article 17(1) and 17(2)

Article 17(3) provides for exemption by the source state of performance income of artistes / sportsperson for performances that are substantially supported by public funds.

OECD Model commentary specifically states that Article 17 will ordinarily apply when the artiste or sportsman is employed by a Government and derives income from that Government. Certain conventions contain provisions excluding artistes and sportsmen, employed in organisations which are subsidised out of public funds, from the application of Article 17. Some countries may consider it appropriate to exclude from the scope of the Article events supported from public funds. Such countries are free to include a provision to achieve this but the exemptions should be based on clearly definable and objective criteria to ensure that they are given only where intended. Such a provision might read as follows:

The provisions of paragraphs 1 and 2 shall not apply to income derived from activities

performed in a Contracting State by artistes or sportsmen if the visit to that State is wholly or mainly supported by public funds of one or both of the Contracting States or political subdivisions or local authorities thereof. In such a case, the income is taxable only in the Contracting State in which the artiste or the sportsman is a resident.

OECD also acknowledges that there could be administrative difficulties involved in allocating to specific activities taking place in a State the overall employment remuneration of individual members of a foreign team, troupe or orchestra, and in taxing the relevant part of that remuneration, some States may consider it appropriate not to tax such remuneration. Whilst a State could unilaterally decide to exempt such remuneration, such a unilateral solution would not be reciprocal and would give rise to the problem. These States may therefore consider it appropriate to exclude such remuneration from the scope of the Article. Whilst paragraph above indicates that one solution would be to amend the text of the Article so that it does not apply with respect to income from employment, some States may prefer a narrower exception dealing with cases that they frequently encounter in practice. The following is an example of a provision applicable to members of a sports team that could be used for that purpose:

The provisions of Article 17 shall not apply to income derived by a resident of a Contracting State in respect of personal activities of an individual exercised in the other Contracting State as a sportsperson member of a team of the first-mentioned State that takes part in a match organised in the other State by a league to which that team belongs.

In its position on the OECD Model, India has reserved the right to exclude from the application of Article 17(1) and Article 17(2), performance income of artistes / sportsperson for performances that are substantially supported by public funds, thereby providing residence based taxation of such income. This reservation finds place in most of the bilateral tax treaties signed by India in form of Article 17(3).

17.4.7 Recent ruling:

Daler Singh Mehndi (2018) 91 taxmann.com 178 (Delhi ITAT)

The Delhi ITAT considered the expression 'may be taxed', and held that income earned by the assessee from performing stage shows in USA, Canada, and Netherlands during assessment years 2001-02 and 2003-04, was not taxable in India in terms of Articles 17/18 (Income of Artists & Athletes) of respective DTAA's. The Revenue had denied DTAA benefits inter alia by relying on section 90(3) [which provides the rights to the Government to define any expression used in the treaty] read with CBDT notification no. 91/2008 which requires such income to be included in total income and thereafter double taxation relief to be claimed. The ITAT noted that section 90(3) was introduced only from 1 April 2004; hence relying on Supreme Court ruling in *Turquoise Investment & Finance Ltd.*, it held that upto assessment year 2004-05, till section 90(3) was introduced, the income earned by the assessee from stage shows performed in Canada, USA and Netherlands, is not chargeable to tax in India.

17.5 References

- *OECD Model Convention and Commentary [2014]*
- *UN Model Convention and Commentary [2011]*
- *US Model Convention and Technical explanation [2006]*
- *Thesis of Author Dick Molenaar – Taxation of International Performing Artistes (part of IBFD Doctorial Series)*
- *Thesis of Author Karolina Tetlak – Taxation of International Sportsmen (part of IBFD Doctorial Series)*
- *Chapter 53 on Artistes and Sportsmen: Article 17 by Ca Rakesh Jariwala, Ca Neeraj Khubchandani and Ca Jay Thakkar published in International Taxation – A Compendium by The Chamber of Tax Consultants*

18. Article 18 – Pensions and Social Security Payments

18.1 Scope of the Article

The globalisation of the economy and the development of international communications and transportation have considerably increased the international mobility of individuals, both for work-related and personal reasons. This has significantly increased the importance of cross-border issues arising from the interaction of the different pension arrangements which exist in various States and which were primarily designed on the basis of purely domestic policy considerations. Therefore, it was felt by both the OECD and UN committee to address these cross border issues on pensions in the tax conventions so as to remove obstacles to the international movement of persons, and employees in particular.

Article 18 of the Model tax conventions deals with pensions and social security payments. This article distributes the taxing rights between the residence state and source state. As a general rule, the pension/annuity articles of most tax treaties allow the country of residence (as determined by the residency article) to tax the pension or annuity under its domestic laws. This is true unless a treaty provision specifically amends that treatment. Some treaties, for example, provide that the country of residence may not tax amounts that would not have been taxable by the other country if you were a resident of that country. In some cases, government pensions/annuities or social security payments may be taxable by the government making the payments. There also may be special rules for lump-sum distributions.

The types of payment that are covered by this Article include not only pensions directly paid to former employees but also to other beneficiaries (e.g. surviving spouses, companions or children of the employees) and other similar payments, such as annuities, paid in respect of past employment. This Article also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19. This Article only applies, however, to payments that are in

consideration of past employment; it would therefore not apply, for example, to an annuity acquired directly by the annuitant from capital that has not been funded from an employment pension scheme. This Article applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could nevertheless constitute a "pension or other similar remuneration".

This article, however does not cover income received by the employees during the tenure of his/her employment.

18.2 Article 18 in various model conventions

18.2.1 OECD Model Commentary [2014]

Text of the Article

ARTICLE 18

PENSIONS

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

18.2.2 UN Model Convention [updated 2011]

Text of the Article

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

Article 18 (alternative A)

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 18 (alternative B)

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.

However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.

Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting

State or a political subdivision or a local authority thereof shall be taxable only in that State.

Two alternative versions are given for Article 18 of the United Nations Model Convention, Article 18 A and Article 18 B.

Article 18 A, like Article 18 of the OECD Model Convention, provides that the State of residence has an exclusive right to tax pensions and other similar remuneration. It departs, however, from the OECD Article by granting to the State of source an exclusive right to tax the payments made within the framework of a public scheme which is part of the social security system of that State or a political subdivision or a local authority thereof.

Under Article 18 B the State of source may tax pensions and other similar remuneration and the provisions of Article 23 A or 23 B will determine whether the State of residence shall exempt such income or shall allow, as a deduction from its own tax on such income, the tax paid in the State of source. Article 18 B allows, however, exclusive source taxation when the payments are made within the framework of a public scheme which is part of the social security system of a State or a political subdivision or a local authority thereof.

18.2.3 USA Model Convention [2006]

Text of the Article

Article 17

Pensions, Social Security, Annuities, Alimony, and Child Support

- (a) *Pensions and other similar remuneration beneficially owned by a resident of a Contracting State shall be taxable only in that State.*
- (b) *Notwithstanding subparagraph a), the amount of any such pension or remuneration arising in a Contracting State that, when received, would be exempt from taxation in that State if the beneficial owner were a resident thereof shall be exempt from taxation in the Contracting State of which the beneficial owner is a resident.*

Notwithstanding the provisions of paragraph 1, payments made by a Contracting State under provisions of the social security or similar legislation of that State to a resident of the other Contracting State or to a citizen of the United States shall be taxable only in the first-mentioned State.

Annuities derived and beneficially owned by an individual resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during a specified number of years, or for life, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

Alimony paid by a resident of a Contracting State to a resident of the other Contracting State shall be taxable only in that other State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement

or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

Periodic payments, not dealt with in paragraph 4, for the support of a child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall be exempt from tax in both Contracting States.

US Model convention, in addition to pension and annuities, also covers additional amounts in the nature of social security benefits, public pensions, alimony and child support as compared to OECD and UN model conventions.

18.3 Article 18 of the OECD and UN Model – Commentary and Interpretation

18.3.1 Right to Taxation

According to this Article, pensions and other similar remuneration paid in respect of private employment are taxable only in the State of residence of the recipient. Reason for giving exclusive right of taxation to residence state is because the State of residence of the recipient of a pension is in a better position than any other State to take into account the recipient's overall ability to pay tax, which mostly depends on worldwide income and personal circumstances such as family responsibilities. Exclusive taxing rights to residence states also avoids imposing on the recipient of this type of pension the administrative burden of having to comply with tax obligations in States other than that recipient's State of residence.

Some States, however, are reluctant to adopt the principle of exclusive residence taxation of pensions and propose alternatives to this Article. Some of these alternatives and the issues that they raise are discussed below in detail, which deal with the various considerations related to the allocation of taxing rights with respect to pension benefits and the reasons supporting the Article as drafted.

18.3.2 Types of Income covered

Various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will be determined by the nature of the payments, having regard to the facts and circumstances in which they are made, as explained in the following paragraphs.

While the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration" are broad enough to cover non-periodic payments. For instance, a lump-sum payment in lieu of periodic pension payments that is made on or after cessation of employment may fall within the Article.

Whether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact. For example, if it is shown that the consideration for the payment is the commutation of the pension

or the compensation for a reduced pension then the payment may be characterised as "other similar remuneration" falling under this Article. This would be the case where a person was entitled to elect upon retirement between the payment of a pension or a lump-sum computed either by reference to the total amount of the contributions or to the amount of pension to which that person would otherwise be entitled under the rules in force for the pension scheme. The source of the payment is an important factor; payments made from a pension scheme would normally be covered by the Article. Other factors which could assist in determining whether a payment or series of payments fall under the Article include: whether a payment is made on or after the cessation of the employment giving rise to the payment, whether the recipient continues working, whether the recipient has reached the normal age of retirement with respect to that particular type of employment, the status of other recipients who qualify for the same type of lump-sum payment and whether the recipient is simultaneously eligible for other pension benefits. Reimbursement of pension contributions (e.g. after temporary employment) does not constitute "other similar remuneration" under Article 18.

Since the Article applies only to pensions and other similar remuneration that are paid in consideration for past employment, it does not cover other pensions such as those that are paid with respect to previous independent personal services. Some States, however, extend the scope of the Article to cover all types of pensions, including Government pensions.

Depending on the circumstances, social security payments can fall under this Article. Social security pensions fall under this Article when they are paid in consideration of past employment, unless paragraph 2 of Article 19 applies. A social security pension may be said to be "in consideration of past employment" if employment is a condition for that pension. For instance, this will be the case where, under the relevant social security scheme:

- the amount of the pension is determined on the basis of either or both the period of employment and the employment income so that years when the individual was not employed do not give rise to pension benefits,
- the amount of the pension is determined on the basis of contributions to the scheme that are made under the condition of employment and in relation to the period of employment, or
- the amount of the pension is determined on the basis of the period of employment and either or both the contributions to the scheme and the investment income of the scheme.

Social security payments that do not fall within Article 18 or 19 fall within Article 21. This would be the case, for instance, for payments made to self-employed persons as well as a pension purely based on resources, on age or disability which would be paid regardless of past employment or factors related to past employment (such as years of employment or contributions made during employment).

Although the above provision refers to the social security system of each Contracting State, there are limits to what it covers. "Social security" generally refers to a system of mandatory protection that a State puts in place in order to provide its population with a minimum level of

income or retirement benefits or to mitigate the financial impact of events such as unemployment, employment-related injuries, sickness or death. A common feature of social security systems is that the level of benefits is determined by the State. Payments that may be covered by the provision include retirement pensions available to the general public under a public pension scheme, old age pension payments as well as unemployment, disability, maternity, survivorship, sickness, social assistance, and family protection payments that are made by the State or by public entities constituted to administer the funds to be distributed. As there may be substantial differences in the social security systems of the Contracting States, it is important for the States that intend to use the provision to verify, during the course of bilateral negotiations, that they have a common understanding of what will be covered by the provision.

18.3.3 Cross-border issues related to pensions

Various issues arise due to the existence of very different arrangements to provide retirement benefits. These arrangements are often classified under the following three broad categories:

- statutory social security schemes;
- occupational pension schemes;
- individual retirement schemes.

The interaction between these three categories of arrangements presents particular difficulties. These difficulties are compounded by the fact that each State may have different tax rules for the arrangements falling in each of these categories as well as by the fact that there are considerable differences in the extent to which States rely on each of these categories to ensure retirement benefits to individuals (e.g. some States provide retirement benefits almost exclusively through their social security system while others rely primarily on occupational pension schemes or individual retirement schemes).

Issues also arise related to mismatches resulting from the differences in the general tax policy of each State adopted with respect to retirement savings. In many States, tax incentives are provided for pension contributions. Such incentives frequently take the form of a tax deferral so that the part of the income of an individual that is contributed to a pension arrangement as well as the income earned in the scheme or any pension rights that accrue to the individual are exempt from tax. Conversely, the pension benefits from these arrangements are taxable upon receipt. Other States, however, treat pension contributions like other forms of savings and neither exempts these contributions nor the return thereon; logically, therefore, they do not tax pension benefits. Between these two approaches exists a variety of systems where contributions, the return thereon, the accrual of pension rights or pension benefits are partially taxed or exempt.

As mentioned above, many States have adopted the approach under which, subject to various restrictions, tax is totally or partially deferred on contributions to, and earnings in, pension schemes or on the accrual of pension rights, but is recovered when pension benefits are paid.

- If the other State of which that individual then becomes a resident has adopted a similar

approach and therefore taxes these pension benefits when received, the issue is primarily one of allocation of taxing rights between the two States.

- If, however, the individual becomes a resident of a State which adopts a different approach so as not to tax pension benefits, the mismatch in the approaches adopted by the two States will result in a situation where no tax will ever be payable on the relevant income.

To deal with the above mismatch problems, both OECD and UN Model Commentaries have suggested to incorporate specific provisions, drafts of which are reproduced below:

UN Model

In order to avoid such unintended result, countries could include in paragraph 1 an additional sentence along the following lines:

However such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by or on behalf of a pension fund established in that other State or borne by a permanent establishment situated therein and the payment is not subject to tax in the first-mentioned State under the ordinary rules of its tax law.

OECD Model

Based on the alternative provisions adopted by various countries in their bilateral treaties, OECD has suggested four (4) alternative drafts which are reproduced herein below:

(a) Provisions allowing exclusive source taxation of pension payments

Under such a provision, the Article is drafted along the following lines:

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration arising in a Contracting State and paid to a resident of the other Contracting State in consideration of past employment shall be taxable only in the first-mentioned State.

(b) Provisions allowing non-exclusive source taxation of pension payments

Under such a provision, the State of source is given the right to tax pension payments and the rules of Article 23 A or 23 B results in that right being either exclusive or merely prior to that of the State of residence. The Article is then drafted along the following lines:

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State. However such pensions and other similar remuneration may also be taxed in the other Contracting State if they arise in that State.

(c) Provisions allowing limited source taxation of pension

Under such a provision, the State of source is given the right to tax pension payments but that right is subjected to a limit, usually expressed as a percentage of the payment. The Article is then drafted along the following lines:

1. *Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.*

2. *However such pensions and other similar remuneration may also be taxed in the Contracting State in which they arise and according to the laws of that State but the tax so charged shall not exceed percentage of the gross amount of the payment.*

Where such a provision is used, a reference to paragraph 2 of Article 18 is added to paragraph 2 of Article 23 A to ensure that the residence State, if it applies the exemption method, is allowed to tax the pension payments but needs to provide a credit for the tax levied by the source State.

(d) *Provisions allowing source taxation of pension payments only where the State of residence does not tax these payments*

Such a provision is used by States that are primarily concerned with the structural mismatch described in paragraph 3.3.4 above. A paragraph 2 is then added along the following lines:

2. *However such pensions and other similar remuneration may also be taxed in the Contracting State in which they arise if these payments are not subject to tax in the other Contracting State under the ordinary rules of its tax law.*

Issues also arise in a situation where some States do not tax pension payments generally or otherwise exempt particular categories or parts of pension payments. In these cases, the provisions of this Article, which provide for taxation of pensions in the State of residence, may result in the taxation by that State of pensions which were designed not to be taxed and the amount of which may well have been determined having regard to that exemption. This may result in undue financial hardship for the recipient of the pension.

To avoid the problems resulting from this type of mismatch, some States include in their tax treaties provisions to preserve the exempt treatment of pensions when the recipient is a resident of the other Contracting State. These provisions may be restricted to specific categories of pensions or may address the issue in a more comprehensive way. An example of that latter approach would be a provision drafted along the following lines:

Notwithstanding any provision of this Convention, any pension or other similar remuneration paid to a resident of a Contracting State in respect of past employment exercised in the other Contracting State shall be exempt from tax in the first-mentioned State if that pension or other remuneration would be exempt from tax in the other State if the recipient were a resident of that other State.

In many States, preferential tax treatment (usually in the form of the tax deferral) is available to certain individual private saving schemes established to provide retirement benefits. These individual retirement schemes are usually available to individuals who do not have access to occupational pension schemes; they may also, however, be available to employees who wish to supplement the retirement benefits that they will derive from their social security and

occupational pension schemes. These schemes take various legal forms. For example, they may be bank savings accounts, individual investment funds or individually subscribed full life insurance policies. Their common feature is a preferential tax treatment which is subject to certain contribution limits.

These schemes raise many of the cross-border issues that arise in the case of occupational schemes, such as the tax treatment, in one Contracting State, of contributions to such a scheme established in the other State.

Further, contribution to foreign pension funds could raise many issues in case of employees employed with multinational enterprises that are expected to work outside their home country from time to time. The terms of service under which staff are sent to work in other countries are of keen interest and importance to both the employer and the employee. One consideration is the pension arrangements that are made for the employee in question.

Individuals working abroad will often wish to continue contributing to a pension scheme (including a social security scheme that provides pension benefits) in their home country during their absence abroad. This is both because switching schemes can lead to a loss of rights and benefits, and because many practical difficulties can arise from having pension arrangements in a number of countries.

The tax treatment accorded to pension contributions made by or for individuals working outside their home country varies both from country to country and depending on the circumstances of the individual case. Before taking up an overseas assignment or contract, pension contributions made by or for these individuals commonly qualify for tax relief in the home country. When the individual works abroad, the contributions in some cases continue to qualify for relief. Where the individual, for example, remains resident and fully taxable in the home country, pension contributions made to a pension scheme established in the home country will generally continue to qualify for relief there. But frequently, contributions paid in the home country by an individual working abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the case it can become expensive, if not prohibitive, to maintain membership of a pension scheme in the home country during a foreign assignment or contract. In this scenario OECD suggests a provision mentioned in paragraph 37 of the commentary on Article 18 which member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions made by or for individuals working outside their home country.

The above issue is restricted to pension schemes established in one of the two Contracting States. As it is not unusual for individuals to work in a number of different countries in succession, some States may wish to extend the scope of the provision to cover situations where an individual moves from one Contracting State to another while continuing to make contributions to a pension scheme established in a third State. Such an extension may, however, create administrative difficulties if the host State cannot have access to information concerning the pension scheme (e.g. through the exchange of information provisions of a tax convention concluded with the third State); it may also create a situation where relief would be given on a non-reciprocal basis because the third State would not grant similar relief to an individual

contributing to a pension scheme established in the host State.

Another issue, which also relates to international labour mobility, is that of the tax consequences that may arise from the transfer of pension rights from a pension scheme established in one Contracting State to another scheme located in the other Contracting State. When an individual moves from one employer to another, it is frequent for the pension rights that this individual accumulated in the pension scheme covering the first employment to be transferred to a different scheme covering the second employment. Similar arrangements may exist to allow for the portability of pension rights to or from an individual retirement scheme.

Such transfers usually give rise to a payment representing the actuarial value, at the time of the transfer, of the pension rights of the individual or representing the value of the contributions and earnings that have accumulated in the scheme with respect to the individual. These payments may be made directly from the first scheme to the second one; alternatively, they may be made by requiring the individual to contribute to the new pension scheme all or part of the amount received upon withdrawing from the previous scheme. In both cases, it is frequent for tax systems to allow such transfers, when they are purely domestic, to take place on a tax-free basis.

Problems may arise, however, where the transfer is made from a pension scheme located in one Contracting State to a scheme located in the other State. In such a case, the Contracting State where the individual resides may consider that the payment arising upon the transfer is a taxable benefit. A similar problem arises when the payment is made from a scheme established in a State to which the relevant tax convention gives source taxing rights on pension payments arising therefrom as that State may want to apply that taxing right to any benefit derived from the scheme.

The issues arising from all these differences generally are required to be fully considered in the course of bilateral negotiations, in particular to avoid double taxation or non-taxation, and, where appropriate, addressed through specific provisions.

18.3.4 The Indian social security system

The Indian social security system is governed by the Employees' Provident Fund and Miscellaneous Provisions Act 1952 and the schemes made there under. The Employees' Provident Fund Organisation (EPFO), a statutory body established by the government of India, administers the social security regulations in India. Every establishment in India, employing 20 or more persons is required to register with the social security authority if not an exempt establishment. An establishment employing less than 20 persons can voluntarily opt to register with the authorities for the welfare of its employees.

The social security system (contribution-based) for formal workers that is overseen by the EPFO under different Acts consists of three streams: the Employee Provident Fund (EPF), Employee Pension Scheme (EPS), and the Employee Insurance Scheme. While the EPF is largely a defined contribution scheme (that provides a lump-sum payment on retirement); the EPS is a defined benefit scheme that pays a pension proportional to earnings at the time of retirement

after a minimum 10 years of contribution. The schemes are partly financed by the contributions from the employer, employee and the government.

18.3.5 India’s Social Security Agreements

Social Security Agreements are binding bilateral reciprocal instruments between two nation states that allow provisions which prevent dual contribution of social security, provide exportability of benefits to third country, and totalisation. As of 2017, India has operationalised Social Security Agreements with countries as under:

Country (effective date)		
Belgium (1 September 2009)	Switzerland (29 January 2011)	Denmark (1 May 2011)
Luxembourg (1 June 2011)	France (1 July 2011)	Korea (1 November 2011)
Netherlands (1 December 2011)	Hungary (1 April 2013)	Sweden (1 August 2014)
Finland (1 August 2014)	Czech Republic (1 September 2014)	Norway (1 January 2015)
Austria (1 July 2015)	Canada (excl. Quebec) (1 August 2015)	Australia (1 January 2016)
Japan (1 October 2016)	Germany comprehensive (1 May 2017)	Portugal (8 May 2017)

18.4 References

- OECD Model Convention and Commentary [2014]
- UN Model Convention and Commentary [2011]
- US Model Convention and Technical explanation [2006]

19. Article 19 – Government Service

UN Model:

1. (a) *Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.*
- (b) *However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:*
 - (i) *is a national of that State; or*

- (ii) *did not become a resident of that State solely for the purpose of rendering the services.*
2. (a) *Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.*
- (b) *However, such pensions and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.*
3. *The provisions of Articles 15, 16, 17, and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.*

19.1 Nature of receipts covered

Salaries, wages, other similar remuneration and pensions paid to an Individual for government services by a Contracting State or Political Sub-division or a local authority thereof are covered under Article 19.

19.2 Exclusive taxing rights

The State who receives the services and pays for such services (“Paying State”) has an exclusive right to tax such income instead of the State, where the employee is working and where the payment is received (“Receiving State”).

Exception: The right of taxation as mentioned supra is not exclusive. Such salary, wages or other similar remuneration shall be taxable only in the Receiving State if the services are rendered in that state, and the individual rendering service is: (a) a resident and a national of Receiving State; or (b) he did not become a resident of that State solely for the purpose of rendering the services. Such taxation is in line with Vienna Convention, according to which, the Receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic mission and consular post, who are permanent residents or nationals of that state²⁴⁹.

19.3 Place of rendering service

The place of rendering service is important in deciding the taxability of such income. The same can be explained by the following examples.

Example 1: Mr. X is a resident and citizen of Germany and who is employed by the Government of France, Mr. X commutes daily to France for employment. The place of rendering services is

²⁴⁹ UN Commentary (2011) Para 2

France. The services are also received by France and as such Mr. X will not fall under the exception mentioned above. If the services were rendered in Germany, then his salary income would have been taxable in Germany (Receiving State). Thus, in the given example, the Salary income will be taxable in France (Paying State).

Example 2: Mr. Y is a French national who is working in the French Embassy in Germany. Mr. Y is a resident of Germany. Since the place of rendering the services is Germany and Mr. Y is a resident of Germany and has become resident of Germany solely for the purpose of rendering such services. Therefore, the salary will be taxable in France (Paying State). If in the given example, Mr. Y was a German national, then the salary income would have been taxable in Germany (Receiving State), as the same would have fallen under an exception to the rule.

19.4 Primary right to tax the “Pension” received by a Government employee

The State paying the pension for the services rendered to it, has the primary right to tax the pension. However, the pension will be taxable in the Receiving State if the individual receiving the pension is a resident and national of that State. The pension may be paid directly by the Government or out of funds created by the Government.

19.5 Employee of government carried on business in other contracting state

The provisions of this Article are not applicable to an employee of Government department or organization that carries on business in the other contracting state. In such case, Article 15 for Wages and Salaries, Article 16 for Director's Fees and other similar payments, Article 17 for Artists and Sportsmen and Article 18 for Pensions will apply as the case may be.

19.6 Meaning of salaries, wages, pension and other similar remuneration

The term salaries, wages and other similar remuneration includes benefit in kind received in respect of services rendered to State or political subdivision or local authority there of (e.g. the use of residence or automobile, health or life insurance coverage and club membership)²⁵⁰. Pension covers periodic payments and is broad enough to cover non periodic payments, e.g. lump-sum payment in lieu of periodic pension payments that are made to former State employees after cessation of employment²⁵¹.

19.7 Domestic tax law provisions

Section 10(7) of the Income Tax Act, 1961, exempts allowances or perquisites paid or allowed as such outside India by the Government to its employees who are citizens of India for rendering services outside India. Section 10(8) exempt foreign income and remuneration received by an

²⁵⁰ OECD Commentary (2010) Para 2.2

²⁵¹ OECD Commentary (2010) para 5.1

individual who is assigned to duties in India from Government of foreign State for services rendered in connection with co-operative technical assistance programmes. Section 10(8A) and 10(8B) exempt remuneration financed by international organizations under a duly approved technical assistance grant agreement between agency and Government of foreign State. Income of any family member of such person is also exempt under section 10(9), if they have any income outside India on which they are liable to pay income or social security tax to Government of that foreign State.

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1. UN Model commentary (2011) & OECD Model Commentary (2010)
2. Compendium – International Taxation – The Chamber of Tax consultants

20. Article 20 – Students

UN Model:

“Payments which a student or business trainee or apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State”.

20.1 Nature of receipts covered

Receipts by a Student or Business trainee or apprentice in the Contracting State (“host State”) for the purpose of his / her maintenance, education or training are covered by this Article. Such payments should be received by student from sources outside the host State in which the student or business trainee or apprentice concerned is staying. The aim of this Article is not to tax receipts in the hands of the students, business trainee or apprentice, which arise from the sources outside that Contracting State and which are used only for maintenance, education or training of such individuals. It may be mentioned that, payments for maintenance, education or training should not exceed the level of expenses that are likely to be incurred to ensure the recipient’s maintenance, education or training.

20.2 Purpose of stay of student

The stay of the student / business trainee / apprentice in the host State should be solely for the purpose of his / her education or training. Thus, Article 20 does not apply if a foreign student does more than just receive education or training in the host State.

20.3 Student must be resident of other Contracting State before visiting the host State

In order to apply this Article, the student must be either at the time of arrival in the host State or

immediately before that, a resident of the other Contracting State. The word “immediately” makes clear that this Article does not cover an individual who has once been a resident of a Contracting State but has subsequently moved his residence to a third state before visiting the host State²⁵².

20.4 Taxability

If the conditions mentioned above are fulfilled, then, such receipts will not be taxed in the host State.

Example 1: Mr. X, a student (Citizen of India) is in U.S. solely for the purpose of his education. He has never visited U.S. before. He regularly receives the payments from his father residing in India, for the purpose of his education and maintenance. Since Mr. X satisfies all the conditions mentioned above i.e. he is present in the U.S. solely for the purpose of his education, he receives payment from a source outside the U.S. and assuming that immediately before visiting the U.S., he was a resident of India, he will not be taxed in the U.S. for the payments received from his father.

Example 2: Continuing the above example, if Mr. X receives as salary from the part time job in the U.S., in such a case, the salary earned by the student is subject to Article 15.

20.5 Domestic tax law

Section 10(16) of the Income Tax Act, 1961, exempts scholarship granted to meet the cost of education. In the context of the scholarship referred to in section 10(16) of the Act, Courts have held as under:-

The fact that the recipient does not spend the whole amount towards education or saves something out of it would not detract from the character of the payment being scholarship – *V.K. Balachandran [1985](147 ITR 4)(Mad HC)*

Exemption was to be allowed even where the surplus saved out of the scholarship received, was utilized for investment purpose – *Girish Saran Agarwal [2007](160 Taxman 79) (Ahmddb ITAT)*

The Act is silent in connection with the money received by a foreign student from his resident country for the purpose of his studies and maintenance in India. Such receipts are as such in nature of capital receipts. However, as per section 56(2)(vii), any sum of money received in excess of Rs. 50,000/- without consideration from any persons other than specified relatives may be treated as income from other sources and taxed accordingly. Thus, in such circumstances this Article certainly grants relief. It may however be noted that a foreign student who is pursuing an educational course in India may become a tax resident of India if he resides in India beyond a threshold time limit prescribed for becoming a resident and in that case, he may liable to tax in India in respect of his world-wide income.

²⁵² UN Model Commentary (2011) Para 2.2

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21. Article 21 – Other Income

UN Model:

1. *Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.*
2. *The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.*
3. *Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.*

21.1 Nature of receipts covered

The 'Other Income' Article is a residuary provision which provides for allocation of taxing rights between the 'Residence State' and the 'Source State' in relation to income 'not dealt with' in the other Articles of the Double Tax Avoidance Agreement (DTAA). In simple language, it can be said that income not dealt with in any of the preceding Articles is dealt under the said Article, it is similar to section 56 and 57 of Income Tax Act, but, it may be mentioned that some type of income like dividend and interest although taxed as 'income from other sources' under the Income Tax Act, will be governed by specific Article under DTAA and not by 'Other Income' Article.

21.2 Right to Tax

The first paragraph of the this Article envisages that other income 'shall be taxable only' in the State of Residence, hence, providing for an exclusive right to the Residence State to tax such income (e.g. India DTAA with Philippines), however, paragraph 3 of this Article also provides right to tax such income to Source State as well. In such case income would be taxable in both the States i.e. the State of Residence and State of Source. Under such scenario, the State of Residence will either grant credit for taxes paid in Source State or exempt such income in

accordance with Article 23 of DTAA.

21.3 Income under the residuary heads includes income from third state

The 'Other Income' Article uses the connotation 'wherever arising' – meaning thereby that it refers to source, giving rise to income in the State of Residence as well as the third State.

21.4 Examples of receipts that may be covered in the Other Income Article

Examples (illustrative only) of items of income that may get covered by this Article include:

- Income from gambling / lottery²⁵³;
- Alimony²⁵⁴;
- Punitive (but not compensatory) damages and covenant not to compete²⁵⁵;
- Securities lending fees derived by an institutional investor²⁵⁶;
- Guarantee fees paid within an intercompany group would be covered by Article 21, unless the guarantor is engaged in the business of providing such guarantees to unrelated parties²⁵⁷;

21.5 Meaning of 'Dealt With'

Para 1 of this Article gives exclusive right of taxation to Residence State, if any items of income is 'not dealt with' in another Articles (Article 6 to Article 20) of DTAA. The meaning of 'dealt with' can be explained by way of an example, suppose that taxability of payment of 'fees for technical services' has been examined under Article 12 (as the fees for technical services is being governed by that specific Article) and in view of non-satisfaction of "make available" condition the same is not taxable in the Source State. In that case, the taxability of the same need not be again examined under 'Other Article' as that item of income has already been 'dealt with' in Article 12 and the fact that it has not been subjected to tax under the Article 12, does not mean that Article 21 should be applied²⁵⁸. A contrary view was however expressed in *MSC Mediterranean Shipping Co [2015](154 ITD 478)(Mum Trib)*. As per this view, 'dealt with' means that the item has been subjected to tax or that the treatment has been detailed under the other Article. Under this view, a mere exclusion of the item under the other Article would not mean that the item has been 'dealt with' in the other Article.

²⁵³ UN Model Commentary (2011) Para 2

²⁵⁴ UN Model Commentary (2011) Para 2

²⁵⁵ US Model Commentary (2006)

²⁵⁶ US Model Commentary (2006)

²⁵⁷ US Model Commentary (2006)

²⁵⁸ *ACIT vs. Viceroy Hotels Ltd [2011] 11 taxmann.com 216 (Hyd); DCIT vs. Andaman Sea Food (P) Ltd [2012] 18 ITR(T) 509 (Kolkata), Gearbulk AG [2009](318 ITR 66)(AAR).*

21.6 What happens if there is no 'Fee for Technical Services' (FTS) Article in the DTAA

There may arise a situation where tax treaty does not contain FTS clause e.g. India treaty with Brazil, United Arab Emirates etc. does not have FTS Article. In such a situation, do we resort to the 'Other Income' Article, since the income is not 'dealt with', at all on account of absence of FTS Article? In such a scenario, the issue with respect to taxation of FTS has been a subject matter of dispute before the Judicial Authorities. The Jurisprudence in this connection may be classified in three different categories:

21.6.1 Taxable as business profit under Article 7

DTAA where there is no specific Article for FTS, Judicial Authorities examined the taxability of FTS under Article 7 relating to 'Business Income' and since there was no Permanent Establishment in Source State, it was held that such FTS was not taxable in India. Since the taxability of royalty / FTS was considered under Article 7, the said payment cannot be taxable under residuary Article of DTAA²⁵⁹.

21.6.2 Taxable as per provisions of the Act

If the provisions of DTAA are silent on FTS Article, FTS is not automatically taxable as Business Income under Article 7 of DTAA, taxability needs to be considered as per provisions of the Act²⁶⁰.

21.6.3 Taxable under residuary article- Other Income

Since there is no specific Article for taxation of FTS in DTAA, hence, it would be governed by Article 21 of DTAA which is residuary article in DTAA²⁶¹.

21.6.4 What happens if there is no 'Other Income' Article in DTAA

Some of the DTAA which India has entered into do not have 'Other Income' Article e.g. Netherland, Libya, etc. In such cases, both the Contracting States may tax the income in their respective states according to their domestic laws.

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21.7 Some recent rulings

Johnson Matthey Public Ltd. Company (2018) 191 TTJ 1 (Del ITAT)

The Delhi Tribunal held that where the assessee, a UK based company, provided guarantee to

²⁵⁹ PT Mckinsey Indonesia vs. DDIT (2013) 29 taxmann.com 100 (Mum), DCIT vs. Andaman Sea Foods Pvt. Ltd. (2012) 22 taxmann.com 400 (Kol), Mckinsey & Company v. DDIT (ITA No. 7624 / Mum/2010),Bangkok Class Industry Co Ltd [2013](257 CTR 326)(Mad HC), ABB FZ-LLC(Mum ITAT)[2016](75 taxmann.com 83)

²⁶⁰ DCIT vs. TVS Electronics Ltd. (2012) 22 taxmann.com 215 (Chennai)

²⁶¹ Lanka Hydraulic Institute Ltd. (2011) 337 ITR 47 (AAR), XYZ [2012](348 ITR 31)(AAR)

various bankers for extending loan facilities to its Indian subsidiaries, the guarantee fee charged by it from those subsidiaries would not fall within the expression of 'interest' and in view of Article 23(3) of the India-UK DTAA, in absence of any specific provision dealing with corporate/bank guarantee recharge, the same had to be taxed in India as other income as per the Act. In so holding the Tribunal observed that it is not the entering of the global corporate agreement outside India that occasions the assessee to charge the guarantee commission, but it is the act of the subsidiary in availing the loan that accrues the guarantee commission to the assessee. As the loan transaction took place in India, it is not open for the assessee to contend that no income accrued to them in India.

Capgemini SA (2016) 160 ITD 13 (Mum ITAT)

Earlier the Mumbai Tribunal had held that where the assessee, a French company, had given corporate guarantee to a French bank, on behalf of its Indian subsidiaries which were extended credit facilities by Indian branches of the said bank, the guarantee commission received by the assessee company did not accrue in India, income clearly arose in France because guarantee had been given by the assessee to a French Bank in France and, therefore, Article 23 of the India – France DTAA had no applicability.

ITO v Rajiv Suresh Ghai (2021) 132 taxmann.com 234 (Mumbai – Trib)

The assessee, an NRI who was a resident of UAE, had paid some unaccounted monies to a builder. The Assessing Officer brought the same to tax u/s 69 although it had not been proved that the incomes representing the unexplained investment were earned in India. The Mumbai Bench held that since assessee had been tax resident of UAE all along with no economic activities in India, unexplained investments by assessee which were inherently in nature of application of income rather than earning of income, could not have been taxed under section 69 as these fall under article 22 (Other Income) of Indo-UAE DTAA which makes such income taxable in country of residence (UAE) unless these investments are proved to be made out of income generated in India.

22. Article 22 – Taxation of Capital

UN Model:

1. *Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.*
2. *Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services may be taxed in that other State.*
3. *Capital represented by ships and aircraft operated in international traffic and by*

boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. *All other elements of capital of a resident of a Contracting State shall be taxable only in that State.*

22.1 Overview

Article 22 deals with taxes on capital / wealth tax, such tax have to be prescribed under Article 2. Taxes on capital constitute complementary taxation of income from capital. Consequently, taxes on given element of capital can be levied, in principle, only by the State which is entitled to tax the income from this element of capital. However, it is not possible to refer purely and simply to the rule relating to taxation of such class of income, for not all items of income is subject to taxation exclusively in one State. Article 22 does not apply to following²⁶²:

- Inheritance Tax
- Estate Duty
- Gift Tax
- Transfer Duties

22.2 Taxing rights

This Article deals with taxing rights on the capital of an enterprise which may be in the following form:

22.2.1 Immovable Property: Capital represented by an immovable property as referred to in Article 6, which is owned by a resident of a contracting state (Residence State) and situated in other contacting state (Source State) may be taxed in Source State.

22.2.2 Movable Property: If a movable property (a) forms part of the business asset of a Permanent Establishment which an enterprise of “Residence State” (State R) has in “Source State” (State S); or (b) pertains to a fixed base available to a resident of State R in Source State for the purpose of performing independent personal service, it may be taxed in Source State.

22.2.3 Ships, boats and aircrafts: Ships and aircraft operated in international traffic and boat engaged in inland waterways transport or any other movable property pertaining to operation of ships, aircrafts and boats is taxable in the Contracting State in which the place of effective management of the enterprise is situated. The said rights of taxation apply only: (1) where an enterprise itself operates ships etc for its own transportation activities; or (ii) while providing ships etc. on time charter basis. It does not apply where the enterprises does not operate the ships etc.

²⁶² UN Commentary (2011) Para 1

Article 22 does not expressly provide the deduction of debts. It is the domestic law of Source state which decides whether debts are deductible for capital tax purpose. Section 2(m) of Wealth Tax Act, 1957 specifically provides the deduction of debts owed by tax payer which have been incurred in connection with taxable assets.

22.3 Domestic tax law

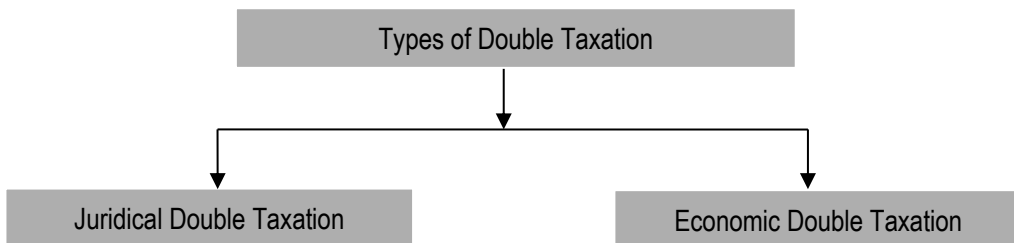
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23. Article 23 – Methods of Elimination of Double Taxation

23.1 Introduction



Generally, most countries follow a mix of residence based taxation and source based taxation leading to double taxation of income.

23.2 Juridical double taxation

When an income is taxed twice in the hands of taxpayers- once in the country of residence and once in the country of source, it leads to '**juridical double taxation**'. Most of the countries majorly face double taxation on account of income being taxed in more than one Country.

Reasons for juridical double taxation:

- Taxation of world-wide income of residents
- Taxation of world-wide income of citizens
- Deemed Dual residency
- Triangular cases

Taxation of world-wide income of residents

Many countries tax the global income of its residents. This results in dual taxation of income in the hands of a taxpayer, once in the Country of his residence and second time in the source

Country.

Eg: A UK subsidiary company remits annual royalty to its Indian parent Company. The Indian Company is taxable on its global income (including royalty) in India under the residence rule and the royalty is taxable in UK under the source rule.

Taxation of world-wide income of citizens

Some countries tax global income of its citizens even when the citizens are residents of another Country. This gives rise to double taxation, once in the Country of citizenship and second in the Country of residence.

Eg: A US citizen who is a tax resident of India would be taxed on its global income in India based on residence rule and in the US based on his citizenship.

Deemed Dual residency

A person may be deemed to be a resident of more than one Country and accordingly, both the countries might tax the global income of such person.

Eg: A person residing in Canada relocates to India and resides in India for 182 days or more during that year then there might be a situation where he is the resident of two countries, leading to taxation of his income in both the Countries.

Triangular cases

Double taxation arises when two countries subject the same person, not being resident of both countries to tax on income arising in a Country.

e.g.: A Company based in India is having a Permanent establishment (PE) in Singapore. If the Singapore PE derives income from Canada, the income of the PE would be taxable in Singapore as well in Canada.

23.3 Economic Double Taxation

These are situations where the same income is taxable in the hands of two taxpayers, e.g. Dividend – is taxed in the hands of the corporate as well as in the hands of the shareholder. This kind of double taxation is known as '**economic double taxation**'.

23.4 Types of Double Taxation Relief

In order to overcome the impact of juridical double taxation, countries enter into bilateral treaties [Double Taxation Avoidance Agreements (DTAA)] in order to allocate the taxing rights, so that income may be taxed only in one Country and be exempt in the other Country. There may still be cases where income is taxed in both the countries. In such cases the treaties provide for allowing credit of taxes paid in source Country.

Alternatively, countries may also allow **unilateral credit** of taxes paid on foreign income when there is no treaty between the Country of residence and Country of source.

Based on the existence of treaty (DTAA), double taxation relief can be divided into two:

Unilateral Tax Relief

Foreign tax credit relief provided to its residents by a Country under the domestic law in the absence of DTAA is referred to as Unilateral relief. Such reliefs are provided in order to eliminate the cascading effect of double taxation.

Bilateral Tax Relief

When two countries enter into a DTAA, then the method of relief is provided in the treaty. The treaty provides for the manner, mode and quantum of tax relief to be allowed in relation to the doubly taxed income in the hands of the taxpayer.

Based on manner provided in the DTAA, the taxpayer shall claim relief on tax in the Country of residence against the income which is doubly taxed.

23.5 Indian Perspective

Chapter IX of the Income-tax Act, 1961 (the Act) contains the provisions relating to double taxation relief. Section 90 of the Act allows the Central Government to enter into treaties with the governments of other countries for granting relief from double taxation. Section 91 of the Act provides for unilateral relief from double taxation in cases where the resident derives income from a Country with which India does not have any agreement.

Pursuant to an amendment brought in by the Finance Act, 2015, CBDT has notified Foreign Tax Credit (FTC) Rule 128 laying down broad principles and conditions for computation and claim of foreign taxes paid in overseas countries by resident taxpayers. These Rules shall come into effect from 1 April 2017. However, prior to this, India did not have any extensive rules/guidelines for computing eligible amount of double taxation relief which had led to immense litigation. The Finance Act, 2015 inserted clause (ha) to section 295(2) to provide that the CBDT can frame rules regarding the procedure for granting foreign tax credit ("FTC") against taxes payable in India.

In exercise of powers conferred by section 295(2)(ha) of the Act, CBDT has inserted Rule 128 of The Income-tax Rules, 1962 vide Notification No. 54 of 2016 dated July 27, 2016. This Rule deals with the manner of computation of foreign tax credit.

23.6 Unilateral relief- An Indian Perspective

Unilateral relief (which is provided under section 91 of the Act) is available to a resident taxpayer who has satisfied the following conditions:

- earned foreign income *and*
- proves that he has suffered tax on such foreign income in any Country outside India by way of deduction of tax at source or otherwise in accordance with the laws in force in that Country on the same income which is subject to tax in India.

In such a scenario, tax deduction is computed as under:

- Ascertain the amount of income which has been subject to double taxation

- On the above income, which is taxed twice, tax shall be calculated at the Indian rate of tax as well as at the foreign rate of tax
- Tax relief is granted by allowing deduction from the tax liability of an amount equal to the lower of the following:
 - ✓ The amount of tax calculated at the Indian rate of tax on the doubly taxed income or
 - ✓ The amount of tax calculated at the foreign rate of tax on the doubly taxed income,

As discussed earlier, the provisions of the Act allow to claim credit of taxes paid in foreign Country if the same income (which is taxed in foreign Country) is chargeable to tax in India. and now, with the newly notified Rule 128, the manner and computation of claiming foreign tax credit has also been prescribed. Rule 128 has come into force w.e.f. April 1, 2017. Therefore, it would generally be understood as applicable from A.Y. 2017-18 onwards.

Rule 128

Particulars	Details
Meaning of foreign tax	<ul style="list-style-type: none"> • In respect of a country with which India has entered into a double taxation avoidance agreement (tax treaty): taxes covered under that tax treaty. • In respect of any other country: the tax payable under the law in force in that country in the nature of income tax.
Mode of payment of foreign tax	Direct payment of tax or by way of deduction
Year of availability	<ul style="list-style-type: none"> • FTC shall be available to the taxpayer in the year in which the income corresponding to such foreign tax has been offered/ assessed to tax in India. • Where the income corresponding to foreign tax is offered to tax in more than one year, FTC shall be available across those years, in proportion to the income offered/ assessed to tax in India.
Tax against which FTC is available	<ul style="list-style-type: none"> • FTC shall be available against the amount of tax, surcharge and cess payable under the Income-tax Act, 1961 (the Act); • FTC shall also be allowed against tax payment under Minimum Alternate Tax (MAT)/ Alternate Minimum Tax (AMT) provisions.

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Particulars	Details
FTC shall not be available	<ul style="list-style-type: none"> • Against payment of any interest, fee or penalty under the Act; • Any amount of foreign tax disputed by the taxpayer.
Availability of credit of disputed foreign tax	<p>Credit of disputed foreign tax shall be available for the year in which the corresponding income is offered to tax or assessed to tax in India, if the taxpayer furnishes the following evidence within 6 months from the end of the month in which disputed foreign tax is finally settled:</p> <ul style="list-style-type: none"> - Evidence of settlement of dispute; - Evidence to the effect that the liability for payment of such foreign tax has been discharged by the taxpayer; and - An undertaking that no refund in respect of such amount has been directly/ indirectly claimed or shall be claimed by the taxpayer
Mode of computation	<ul style="list-style-type: none"> • Total available FTC shall be the aggregate of the amounts of FTC computed separately for each source of income arising from a particular country. • FTC shall be the lower of: <ul style="list-style-type: none"> - Tax payable under the Act on such income; or - Foreign tax paid on such income <p>Where the foreign tax paid exceeds the amount of tax payable under the provisions of tax treaty, such excess amount shall not be considered.</p>
Rate of exchange for conversion of FTC	Telegraphic transfer buying rate (adopted by State Bank of India) on the last day of the month immediately preceding the month in which such tax has been paid or deducted.
MAT/ AMT credit to be carried forward	Any excess of FTC available against tax payable under the MAT/ AMT provisions as compared to the tax payable under the normal provisions shall be

Particulars	Details
	ignored while computing the MAT/ AMT credit
Documents required in order to claim FTC	<p>The taxpayers shall be required to furnish following documents on or before due date of filing of tax return under the Act:</p> <ul style="list-style-type: none"> • A statement of foreign income offered to tax and the foreign tax deducted or paid on such income in Form No. 67; and • Certificate or statement specifying the nature of income and foreign tax deducted or paid: <ul style="list-style-type: none"> - From the tax authority of the foreign country; or - From the person responsible for deduction of such tax; or - Signed by the taxpayer accompanied by proof of tax payment and/ or proof of deduction.
Reporting in relation to refund of foreign taxes	Taxpayer is required to report, in Form 67, the refund of foreign taxes on account of carry-backward of current year losses in overseas country, if any, which have been availed as FTC in India.

Position prior to insertion of Rule 128

As mentioned above, since prior to insertion of Rule 128, India did not have any extensive rules/guidelines for computing eligible amount of double taxation relief, there was immense litigation on this account. Therefore, for dealing with issues relating to analysing meaning of the term ‘income’ or ‘doubly taxed income’, basis of claiming tax credit, aggregation of income earned from several foreign countries, availability of foreign credit in case of loss in India, etc. jurisprudence in this area has emerged only from judicial precedents which are discussed below:

Meaning of expressions “income” and “Doubly taxed income”- Computation of relief on gross foreign income or income net of deductions

- The term or expression ‘income’ in the said section is not an exact quantum or measure of the income as computed either in India or abroad for the purpose of taxation in the respective countries. Instead, it means the ‘income’ as ordinarily understood in a commercial business sense before providing any deduction (say under section 35B of the Act). This is so, because the Indian tax laws may not be identical to that of another Country and the computation of income in both the countries would not result in the same quantum of income. Accordingly, the curtailment of benefit in the form of Foreign Tax

Credit by imputing deduction claimed under section 35B of the Act to the income from the Country abroad was clearly erroneous and the assessee was allowed credit.

- Madras High Court in the case of CIT v. O.VR.SV.VR. Arunachalam Chettiar²⁶³ has held that the expression 'doubly taxed income' means income which is actually taxed in two Countries. In other words, relief would only be available proportionately on the income that is doubly taxed.

Aggregation of income/losses from several foreign countries

At the time of computing credit, should the income as well as tax in all the countries be clubbed together or should credit be computed on a Country to Country basis?

The Bombay High Court in the case of Bombay Burmah Trading Corpn. Ltd.²⁶⁴ dealt with a case where the assessee had its business in India, Tanzania and Thailand. Assessee had incurred losses from Thailand business whereas earned income from Tanzania. The assessing officer adjusted the losses from Thailand business towards the income from Tanzania for the purpose of computing relief under section 91(1).

The High Court held that under Explanation (iii), the expression 'rate of tax of the said Country' has been defined to mean Income-tax paid in the said Country in accordance with the corresponding law in force in that Country. If section 91(1) is analysed with the Explanation, it is clear that the scheme of the said section deals with granting of relief calculated on the income Country-wise and not on the basis of aggregation or amalgamation of income of all foreign countries. Basically under section 91(1), the expression 'such doubly taxed income' indicates that the phrase has reference to the tax which foreign income bears when it is again subjected to tax by its inclusion in the computation of income under the Indian Income-tax Act. Further, section 91(1) shows that in the case of unilateral relief provided to the resident, the relief is allowed at Indian rate of tax or at the rate of tax charged in the other Country, whichever is less.

Therefore, the relief under section 91(1) is provided by way of reduction of tax (i.e. by deducting the tax paid abroad) on such doubly taxed income from tax payable in India. Hence, the relief can be worked out only if it is implemented Country-wise.

Relief under section 91 against Book profit computed under section 115JB of the Act

Would relief under section 91 of the Act be available if the assessee is liable to pay tax under the provisions of section 115JB of the Act?

The issue was analysed by the Mumbai Tribunal in the case of Hindustan Construction Co. Ltd. v. DCIT²⁶⁵ and it was held that when assessee had included the income earned abroad in the calculation of its book profits, he would be entitled to relief under section 91, on such doubly taxed income.

Timing of payment of taxes outside India not relevant for claiming credit

²⁶³ 49 ITR 574

²⁶⁴ 126 Taxman 403

²⁶⁵ 25 SOT 359

Timing of payment of taxes outside India has been analysed in the case of *JCIT v. Petroleum India International*²⁶⁶. In the said case, the assessee had claimed relief under section 91(1) of the Act on taxes paid in Kuwait. However, the Assessing Officer disallowed the assessee's claim of relief under section 91(1) of the Act for the reason that the assessee had not paid taxes in Kuwait before the end of the previous year and had made actual payment of taxes in five instalments in subsequent year.

The Mumbai Tribunal in the above case held that the language of section 91(1) of the Act is unambiguous and provides that where the assessee proves that in respect of his income, which accrued or arose during the previous year outside India, he had paid tax in any Country with which there is no agreement under section 90 for the relief or avoidance of double taxation, he shall be entitled to deduction from the Indian income tax payable by him of a sum calculated on such doubly taxed income. Nowhere in the provision of section 91(1), is it provided that the payment of taxes outside India shall be during the relevant previous year itself. The purpose of provision of section 91(1) is to provide relief in a case where assessee has paid taxes outside the Country and not to subject such assessee to double taxation on the same income. The assessee had discharged its onus of proving that it had in fact made the payment of taxes in a foreign Country in subsequent periods.

Also, the said case pertained to income which arose in Kuwait. It is pertinent to mention here that India has a Limited Agreement with Kuwait for avoidance of double taxation of income derived from international air transport, still relief was allowed to the assessee under Section 91(1) of the Act. From this, it may be inferred that in case of limited agreements, tax relief may be available under section 91(1) in respect of incomes which have not been dealt with in the limited agreements.

Relief under section 91 if relief not available under the tax treaties - State taxes

A treaty defines the taxes with respect to which credit shall be provided under it. Accordingly, if a tax of the source Country is not mentioned in a treaty, credit for the same may not be available to the assessee under section 90 of the Act.

However, in the case of *Tata Sons Ltd. v. DCIT*²⁶⁷, it was held that since India- Canada and India US treaty only allow credit for federal taxes and not state taxes, no relief would be available in respect of state taxes under section 90. The Tribunal examined the allowability of state taxes as deduction under section 37(1) vis-à-vis eligibility of relatable credit under section 90/91 of the Act. It was finally concluded that the tax credit would be allowed under section 91 of the Act since the treaty does not refer to State/Federal taxes. In other words, provisions of treaty or the Act (section 91) whichever, is more beneficial for the assessee should be applied.

However, in the case of *Manpreet Singh Gambhir* (supra), the Delhi Tribunal declined to allow a credit for state income tax paid in the US without examining section 91 of the Act. The Tribunal held referring to Article 2 of the India-USA DTAA that the taxes covered under the DTAA are in respect of taxes paid in the United States only for the Federal Income-tax imposed by internal

²⁶⁶ 26 SOT 105

²⁶⁷ 10 taxmann.com 87(Mum)

revenue code and not the State Income-tax.

23.7 Bilateral relief

Two countries negotiate an agreement (DTAA) for providing double taxation relief, such relief is known as bilateral relief. These agreements provide for the right to a Country to tax an item of income or a taxable person and also provide for the manner, mode and quantum of tax relief to be allowed to doubly taxed income.

23.8 Model Conventions

Article 23 of the UN as well as the OECD Model Convention contains the provisions relating to elimination of double taxation. The said Model Conventions specify two approaches- Exemption method (Article 23A) and Credit method (Article 23B). These methods are not mutually exclusive and there may be cases where a treaty may adopt exemption method for certain types of income and credit method for other incomes.

The snapshot of these methods is given below:

Exemption method	Credit method
<i>Full exemption</i> Doubly taxed incomes do not form part of income of Country of residence	<i>Full credit</i> Deduction is allowed for the entire taxes paid in the source Country
<i>Exemption with progression</i> Country of residence considers doubly taxed income only for the purpose of determination of effective tax rate.	<i>Ordinary credit</i> Deduction qualified based on taxes paid in the Country of residence
	<i>Tax sparing credit</i> Notional credit is provided in the Country of residence based on tax which would have been payable in the source Country but for the incentives granted.
	<i>Underlying tax credit</i> Credit of taxes paid by corporate assessee in the hands of the shareholders.

23.9 Methods of allowing relief from double taxation

Different methods of elimination of double taxation have been discussed below:

23.9.1 Exemption method

Exemption method is the simplest method to avoid double taxation and refers to a situation wherein the Country of residence gives away its right to tax certain incomes in favour of the source Country.

It is most commonly used in cases where developing countries import capital and technology from developed Countries. Developing Countries provide fiscal incentives (by way of exemptions/tax holidays/reduced rate of taxes etc) in order to attract inflow of capital. However, if the Country of residence would tax the income earned by the exporter, then the benefit extended by the developing Country to the capital/technology exporter from developed Country may be neutralized. In such a situation, exemption method ensures that the benefit that is intended for capital/technology exporter is retained by the exporter and not neutralized by imposition of tax in the Country of residence.

The exemption method majorly focusses on income. The two variants followed under this category are:

- Full exemption method and
- Exemption with progression method

Full exemption method

Under full exemption method, income is exempted fully in the Country of residence in respect of income earned and taxed in the source Country. In other words, the Country of residence is not entitled to consider the income earned in the source Country while computing income earned in Country of residence.

For easy understanding, an illustration for computation of relief under ‘full exemption’ method for AY 2016-17 has been tabulated below:

SI. No.	Particulars	Amount (in Rs.)
1	Income earned in Country of residence	1,000,000
2	Income earned in source Country	300,000
3	Total income earned by the individual [1+2] in case there is no exemption	1300,000
4	Tax liability on (3) above based on income tax slab (including surcharge and education cess)	221,450
5	Total income to be considered under full exemption method [only (1) above can be included]	1,000,000
6	Tax liability on (5) above based on income tax slab (including surcharge and education cess)	128,750

India’s perspective:

India generally does not follow full exemption method. But under India – Brazil Double Taxation Avoidance Agreement (‘DTAA’), full exemption method is applied in respect of dividend income.

Article 23 (3) and (4) of the said DTAA reads as under:

“ARTICLE 23 – Methods for the elimination of double taxation-

3.576 International Tax — Practice

3. Where a company which is a resident of a Contracting State derives dividends which, in accordance with the provisions of paragraph 2 of Article 10 may be taxed in the other Contracting State, the first-mentioned State shall exempt such dividends from tax.

4. Where a resident of India derives profits which, in accordance with the provisions of paragraph 5 of Article 10 may be taxed in Brazil, India shall exempt such profits from tax.”

Similarly, under the India – Greece treaty, full exemption is available with respect to dividend. However, the said exemption has not been provided under the ‘Elimination of Double Taxation Article’ but directly in the Article dealing with chargeability of dividend (as reproduced below):

‘Dividends paid by a company which is a resident of one of the territories to a resident of the other territory may be taxed only in the first-mentioned territory.’

Exemption with progression method

Under exemption with progression method, income earned in the source Country, though considered as exempt, is included in total income in the Country of residence only for the purpose of determining effective tax rate. To make it simple, Country of residence does not impose tax on such foreign income but includes such exempt income for the purpose of computing the tax rate applicable on the remaining income.

For easy understanding, an illustration of computation of relief under ‘exemption with progression’ method for AY 2016-17 has been tabulated below:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned in Country of residence	1,000,000
2	Income earned in source Country	300,000
3	Total income earned by the individual [1+2]	1300,000
4	Tax liability on (3) above based on income tax slab (including surcharge and education cess)	221,450
5	Effective tax rate [i.e. (4)/ (3) * 100]	17.03%
6	Total income to be considered under exemption with progression method [only (1) above can be included]	1,000,000
7	Tax liability on (6) above based on the effective rate as computed in (5)	170,300

Most of the tax treaties signed by India with other countries include exemption with progression. Some of them are – Malaysia, Italy, Australia, Canada, China, Denmark, Hungary, Luxemburg, Japan etc.

E.g. under India – Singapore DTAA, India applies exemption with progression method in respect of certain items of income that may be taxed in Singapore. Article 25 (6) of the said DTAA reads as under:

“6. Income which, in accordance with the provisions of this Agreement, is not to be subjected to

tax in a Contracting State, may be taken into account for calculating the rate of tax to be imposed in that Contracting State.”

23.9.2 Credit method

Under the principle of credit, the Country of residence would determine the resident's worldwide income (including the foreign sourced income) and compute the tax liability thereon. From the tax liability so computed, the Country of residence would grant a deduction in respect of foreign tax paid on the foreign sourced income.

If the tax payable in the Country of residence is more than the taxes paid in the source Country, then the resident would be liable to pay the differential tax in the Country of residence. If the foreign tax exceeds the resident Country tax on the same income, the excess tax credit may be carried forward or forfeited. As per the provisions of DTAA entered by India, such excess FTC is forfeited.

The main feature of the credit method is that the Country of residence retains the right to tax the foreign income but it allows credit for the taxes paid in the source Country.

Most of the DTAA relieve double taxation only through credit method. For a Country of residence, the loss of revenue is lower in credit method. Hence, generally, most countries prefer the credit method. It may be noted that India follows credit method for most of the incomes.

This method of relief focusses on tax liable rather than the income taxable. The variants to the credit method are:

- Full credit method
- Ordinary credit method
- Tax sparing credit method and
- Underlying Tax credit method

Full credit method

Under this method, the Country of residence allows full credit for tax paid in the source Country in respect of income taxed in the Country of residence. In other words, tax paid in the source Country will be allowed as a credit in the Country of residence in respect of income doubly taxed.

India does not follow full credit method for giving credit to its residents except in case of Namibia DTAA where full credit is provided in respect of taxes paid in Namibia.

Under India-Canada DTAA, Canada provides full credit to its residents for taxes paid in India. Article 23 of the said DTAA reads as under:

“2. In the case of Canada, double taxation shall be avoided as follows:

(a) Subject to the existing provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada and to any subsequent modification of those provisions - which shall not affect the general principle hereof - and unless a greater deduction or relief is provided under the laws of Canada, tax payable in India on profits, income

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or gains arising in India shall be deducted from any Canadian tax payable in respect of such profits, income or gains.”

For easy understanding, an illustration of computation of relief under ‘full credit’ method for AY 2016-17 has been tabulated below:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned in Country of residence	1,000,000
2	Income earned in source Country	300,000
3	Total income earned by the individual [1+2]	1300,000
4	Tax paid in Source Country on (2) say at 20% - this shall be provided as full credit in the Country of residence	60,000
5	Tax liability in Country of residence on (3) above based on income tax slab (including surcharge and education cess)	221,450
6	Net tax liability in the Country of residence after providing relief of full credit of taxes paid in source Country [i.e. (5)-(4)]	161,450

Ordinary credit method

Under ordinary credit method, Country of residence allows a deduction of the total taxes paid in the source Country, However, the maximum deduction is restricted to the extent the taxes that would have been paid on such income in its own Country.

Therefore, the taxpayer shall be liable to pay the deficit tax if the domestic Country equivalent tax exceeds the foreign tax paid on the same income. However, in case excess foreign tax is paid by the assessee (i.e. in excess to the tax payable in the domestic Country on the same income), the foreign tax which exceeds the home tax, such excess is not refunded.

For eg: India-USA DTAA, allows ordinary credit to its residents for the taxes paid in USA on foreign income. Article 25 (relevant extract) of the said DTAA reads as under:

*“2. (a) Where a resident of India derives income which, in accordance with the provisions of this Convention, may be taxed in the United States, India shall allow as a deduction from the tax on the income of that resident an amount equal to the income-tax paid in the United States, whether directly or by deduction. **Such deduction shall not, however, exceed that part of the income-tax (as computed before the deduction is given) which is attributable to the income which may be taxed in the United States.**”*

For easy understanding, an illustration of computation of relief under ‘ordinary credit’ method for AY 2016-17 has been tabulated below:

Sl. No.	Particulars	Amount (in Rs.)
1	Income earned in Resident Country	1,000,000

Sl. No.	Particulars	Amount (in Rs.)
2	Income earned in Source Country	300,000
3	Total income earned by the individual [1+2]	1300,000
4	Tax paid in Source Country on (2) say at 20%	60,000
5	Tax liability in Resident Country on (3) above based on income tax slab (including surcharge and education cess)	221,450
6	Effective tax rate for taxes paid in Resident Country [i.e. (5) / (3) * 100]	17.03%
7	Relief provided under ordinary credit method [i.e. (2) * (6)] – as the effective rate of tax in Resident Country is lesser, credit is restricted to the rate applicable in Source Country	51,090
8	Net tax liability in Resident Country after providing relief under ordinary credit method of taxes paid in Source Country [i.e. (5)-(7)]	170,360

In the said method of relief, it may be noted that, extra tax paid in source Country (as seen in the above illustration) is an additional liability to the taxpayer.

Tax Sparing Credit method

If income earned in the source Country is exempted under the domestic laws (say, section 10 of the Act), the actual tax payment in the source Country may be Nil. However, under 'Tax Sparing credit method', the taxpayer would get credit of an amount of tax which would have been paid in source Country had there been no such exemption on the said income under the domestic tax laws.

The rationale for providing tax sparing credit is similar to that of 'exemption method'. Tax sparing credit can be applied only if there is a specific provision to that effect in the tax treaty which enables tax credit for taxes that are spared by the source Country.

Some of the treaties entered into by India provide tax sparing credit against tax concessions granted by India under specific sections of the Act. Whereas certain tax treaties viz, India – China, India – Japan, etc., allow tax sparing credit in respect of the tax which would have been payable but for the legal provisions concerning tax reduction, exemption or other tax incentives of India for promotion of economic development. These provisions do not list specific sections but are general in nature.

Tax sparing can be illustrated by a simple example:

- India-Canada DTAA provides for a tax rate of up to 15 percent on interest.
- India exempts tax on interest payable by Government on moneys borrowed by it to sources outside India under section 10(15)(iv) of the Act.

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- India-Canada DTAA provides that where a Canadian resident receives interest from a resident of India, Canada shall grant a foreign tax credit equal to the amount of tax payable in India by the Canadian resident.
- The treaty provides that the term 'tax payable in India' shall, with respect to a company which is a resident of Canada, be deemed to include any amount which would have been payable as Indian tax but for a deduction allowed in computing the taxable income or an exemption or reduction of tax granted for that year under section 10(15)(iv) (the tax-sparing provision).
- Suppose, Co. A, a Canadian-resident corporation, lends money to the Government of India and receives an interest payment of INR 400,000. Tax Credit available to Canadian Resident is computed as under:

Sl. No.	Particulars	Amount (in Rs.)
1	Interest income earned by Canadian-resident	4,00,000
2	Tax payable in Canada @ 40%	1,60,000
3	Foreign tax credit under tax sparing credit method– taxes payable in India as per India-Canada DTAA @ 15% if the interest income is not treated as exempt (i.e. 15% of interest income)	60,000
4	Tax payable in Canada after Foreign Tax Credit (i.e. 2 – 3)	1,00,000

Similarly, if an Indian company sets up an undertaking in a tax holiday unit in another country, profits from that undertaking are not taxed in that other country. Under the treaty, India is required to grant credit for the notional tax liability in the foreign country though the taxes are not paid in that country.

Against this background, it may be noted that sub-rule (8) of the newly inserted Rule 128 requires an assessee to furnish Form No. 67 and proof of payment/deduction of tax. As tax credit under tax sparing clause is for notional tax amount, assessee would not be able to submit documentary evidence regarding tax deduction/payment. An issue may arise whether the tax authorities can refuse to grant credit in respect of such notional tax on the ground that procedure prescribed under Rule 128(8) is not complied with. In such cases, the assessee may contend that the credit is granted under treaty and treaty would override the provisions of the Act. Also, the procedure in Rule 128(8) cannot be complied with in the given circumstances. Therefore, tax authorities should grant credit in such cases.

In such a case, the assessee may examine the possibility of obtaining a certificate from tax authority of the source state specifying the nature of income and amount of tax liability, had the tax holiday not been granted to the assessee, and filing Form No. 67 with such certificate.

Underlying Tax Credit method

Underlying Tax Credit ('UTC') method is a method of providing credit wherein credit on account of foreign taxes paid may be given, in Country of residence, for the tax paid on the underlying profits out of which the dividend is paid by a company in the source Country.

The credit as described under the UTC method can be availed only if there is a specific provision to that effect in the tax treaty. DTAA generally prescribe minimum shareholding required to be eligible for claiming credit under UTC method.

Most of the treaties allowing credit under UTC method provide that where a Company resident in India declares dividend, and the foreign company receiving such dividend declared by the Indian Company either directly or indirectly holds 10/25 percent of the voting power or issued capital of the Indian Company, then in such situation, the foreign company receiving dividend gets credit for corporate taxes paid on such profits out of which dividend is declared.

Few DTAA with India contain UTC provisions, viz, DTAA executed with China, Australia, Ireland, Japan, Malaysia, Mauritius, Singapore, Spain, UK, United Mexican States, USA.

Under India-Singapore DTAA, India provides UTC to a company resident in India deriving dividend from Singapore Company for the taxes paid by Singapore Company in respect of the profits out of which such dividend is paid. Article 25 of the said DTAA reads as under:

"2. Where a resident of India derives income which, in accordance with the provisions of this Agreement, may be taxed in Singapore, India shall allow as a deduction from the tax on the income of that resident an amount equal to the Singapore tax paid, whether directly or by deduction. Where the income is a dividend paid by a company which is a resident of Singapore to a company which is a resident of India and which owns directly or indirectly not less than 25 per cent of the share capital of the company paying the dividend, the deduction shall take into account the Singapore tax paid in respect of the profits out of which the dividend is paid. Such deduction in either case shall not, however, exceed that part of the tax (as computed before the deduction is given) which is attributable to the income which may be taxed in Singapore."

However, for Indian residents, UTC is available only under the DTAA with Singapore and Mauritius. Under other DTAA, UTC is available only to taxpayers in other countries and not to Indian residents.

Further, since there are no provisions in domestic laws which allow credit for underlying taxes paid by overseas subsidiaries, it could be reasonably inferred that no credit for underlying taxes would be available otherwise.

Against this background it may be noted that sub-rule (5) of the newly inserted Rule 128 permits credit for tax paid on such income (i.e. tax paid on the income which is taxed in India as well as other country). The language of Rule 128(5) may not necessarily support underlying tax credit. However, the provisions of the tax treaty would prevail over the domestic law and on that basis it would generally be possible to claim such underlying credit as well. Nevertheless, total credit would be capped to the amount of tax payable in India on such income.

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UTC is illustrated as under:

- Company X Ltd. has an income of Rs. 100,000 in the source Country
- Company Y Ltd. is a holder of 50% of the share capital of company X Ltd
- Tax rate applicable in the source Country is 30% and withholding tax rate applicable is 5%
- Tax rate applicable in Country of residence is 40% (the Country in which Y Ltd. is situated)

In the source Country:

SI. No.	Particulars	Amount (in Rs.)
1	Income earned by X Ltd. in the source Country	100,000
2	Tax paid in the source Country @ 30% on (1)	30,000
3	Income after tax (i.e. 1 – 2)	70,000
4	Dividend distributed by X Ltd. in the source Country	70,000
5	Taxes withheld by X Ltd. in the source Country @ 5% on (4)	3,500
6	Share held by Y Ltd. in X Ltd.	50%
7	Underlying Tax Credit available for Y Ltd. in the Country of residence [i.e. (2) * 50%]	15,000
8	Foreign Tax Credit available for Y Ltd. in the Country of residence [i.e. (5) * 50%]	1,750

In the Country of Residence:

SI. No.	Particulars	Amount (in Rs.)
1	Income earned by Y Ltd. in Country of residence (including dividend received)	135,000
2	Tax payable in the Country of residence @ 40% on (1)	54,000
3	Foreign Tax Credit available [as per point (8) of earlier table]	1750
4	Underlying Tax Credit available [as per point (7) of earlier table]	15,000
5	Balance tax payable by Y Ltd. in Country of residence (i.e. 2 – 3 -4)	37,250

Switch-over clauses

In order to facilitate a taxpayer to change the method of credit on foreign taxes from exemption method to the credit method, in some countries, 'switch-over clauses' are included in their DTAA.

The aim of such a clause is essentially to avoid double non-taxation, which can arise when

exemption method applies.

Switch-over clauses usually allow the Country of residence to retain the right to apply credit method instead of exemption method. The above clause may be allowed subject to fulfilment of certain conditions.

Article 6(c) of the Protocol to India- Germany DTAA reads as under:

“The Federal Republic of Germany shall avoid double taxation by a tax credit as provided for in paragraph (1b) of Article 23, and not by a tax exemption under paragraph (1a) of Article 23,

(aa) if in the Contracting States income is placed under differing provisions of the Agreement or attributed to different persons (other than under Article 9) and this conflict cannot be settled by procedure pursuant to Article 25 and

(i) if as a result of such placement or attribution the relevant income would be subject to double taxation ; or

(ii) if as a result of such placement or attribution the relevant income would remain untaxed or be subject only to inappropriately reduced taxation in the Republic of India and would (but for the application of this paragraph) remain exempt from tax in the Federal Republic of Germany; or

(bb) if the Federal Republic of Germany has, after due consultation and subject to the limitations of its internal law, notified the Republic of India through diplomatic channels of other items of income to which it intends to apply this paragraph in order to prevent the exemption of income from taxation in both Contracting States or other arrangements for the improper use of the Agreement.”

Thus, countries may apply switch-over clauses in circumstances in which double non-taxation arises. Double non-taxation may arise as a consequence of the application of different provisions of the DTAA to the same fact pattern by the two contracting states or in cases of abuse of the provisions of the DTAA.

Switch over clauses can be applied only if there is a specific provision to that effect in the tax treaty.

23.10 Issues in claiming Foreign Tax Credit - India perspective.

General Principle- Treaties between India and Foreign Countries

The DTAA entered into by India generally follow the principle of allowing credit of taxes paid in the source Country against the tax liability arising in India in respect of the foreign tax. Also, the tax treaties generally prescribe that the computation shall be subject to the restriction and limitation of the domestic tax laws of the Country granting the credit.

Before the introduction of FTC rules by CBDT, Indian tax payers faced difficulty in claiming foreign tax credit making such tax a sunk cost to them.

While, with the introduction of Rule 128, some of the issues have been dealt with, many other

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continue to be in ambiguity. Further, the provisions of Rule 128 also give rise to new issues.

These issues need to be dealt with, or else it would continue to hamper globalization and free inflow/outflow of capital/transaction between India and foreign Countries.

A few practical issues are discussed below:

Meaning of “*in accordance with the provisions of the convention*”

The Model Convention as well as treaties provide that the Country of residence shall allow credit for foreign taxes paid only if the income is taxed in the source Country ‘*in accordance with the provisions of the convention*’²⁶⁸.

The above term if interpreted differently by the source Country and the Country of residence or applied differently to the facts of the matter then allowability of credit for foreign taxes can get jeopardized.

For eg: The clause of Permanent establishment (PE) may be interpreted differently by the source Country and by the Country of residence. If the source Country holds that an enterprise has a PE in the source Country but the Country of residence does not agree with the same and the DTAA provides exemption to PE from tax in the Country of residence, then issues will arise with respect to taxability of the PE due to different interpretation by the two Countries.

However, the Madras High Court in the case of CIT v. Lakshmi Textile Exporters Ltd.²⁶⁹ held that, where profits of a PE are exempt from tax in the Country of residence the Country of residence has to accept a finding of the source Country that a Permanent Establishment exists in the source Country. Also, if the source Country chooses to give exemption to such income under its laws then also such income would be treated as “taxed in accordance with the convention” and the Country of residence would not have the right to tax such income.

In the case of Bhavin A. Shah (TS-130-ITAT-2017(Ahd)), the Ahmedabad Tribunal clarified that the Taxpayer will be eligible to claim FTC in respect of income which is taxed both in India and the US, irrespective of whether such taxes are paid directly or by way of withholding. The Tribunal also clarified that FTC can be claimed only if a taxpayer qualifies as a treaty resident and the taxes paid/withheld in the source state is in accordance with the provisions of the applicable DTAA. It concludes that FTC, however, will be limited to the amount computed based on the withholding rate prescribed in the applicable DTAA. This aspect is in line with the Indian Rules on claim of FTC, which provide that where the foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the applicable DTAA, such excess shall be ignored for the purposes of computing FTC.

Definition of “may be taxed”

The right of exclusive taxation was given to Countries under various provisions of Double Taxation Agreement. One Country can tax the income according to the provisions of DTAA and

²⁶⁸ Sanofi Pasteur Holding SA 30 taxmann.com 222 (AP)

²⁶⁹ 245 ITR 521

the other country can allow credit of such tax paid. The OECD model and UN model provide that gains arising from the alienation of immovable property may be taxed in the state of situs. It appears that the state of situs does not have any exclusive right to tax. This view is also supported by the argument that the Article 4 uses the term “shall be taxable” in the other contracting state.

In *CIT vs. S.R.M Firm*²⁷⁰, the Madras High Court has held that the contention on behalf of the revenue that wherever the enabling words such as “may be taxed” are used there is no prohibition or embargo upon the authorities from assessing the category of income, cannot be countenanced as of substance or merit. The court held that the revenue cannot take advantage of such enabling language to claim it as a right to bring to assessment the income covered by such clauses.

The Madras Tribunal in *P.V.AL Kulandagan Chettiyar ITO*²⁷¹ has observed that “considering that the object of agreement is avoidance of double taxation and not relief from double taxation which is well known expression, does not find a place in the preamble, the necessary interpretation should be that it is only Malaysia, that can levy the tax. if India can also levy tax, it will frustrate the object of avoidance of double taxation with which the agreement is made. Even without the agreement, Malaysia can tax the property income which arises in Malaysia to the assessee who will be a non –resident as far as Malaysia is concerned. So, the object cannot be confer Malaysia with power to tax which it already possesses. The object can only be to take away or restrict the existing power of Indian Government to tax income from such properties, so that double taxation can be avoided.

By applying the rationale of the above judgment, it may be held that if any income or gain is taxed in one Country, the same cannot be taxed in the other Country. However, this view may be subject to review as DTAA cannot take away the right of the other Country to tax the income. The object of DTAA is not to take away the right of the other Country to assess any receipt as income and purpose of DTAA is to minimize the tax burden by allowing credit for tax paid.

Further, paragraph 7 of OECD Commentary on Article 23A and 23B states that if the attribution of right to tax is not exclusive, the relevant Article states that the income or capital in question “may be taxed” in the contracting state of which the tax payer is not a resident. Thus, OECD commentary also seems to suggest that credit method should be used in cases where the expression “may be taxed” has been used.

Notification no.91/2008 dated 28 August 2008 provides that in cases wherein in exercise of the powers conferred by sub-section (3) of section 90 of the Act, the Central Government has notified that 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

²⁷⁰208 ITR 400

²⁷¹ 3 ITD 426

the provisions of the Act, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement.

Based on the notification as well as OECD commentary it may be concluded the expression “may be taxed” should be interpreted to mean that the Country of residence along with the source Country has a right to tax the income. Further, this approach would reduce litigation chances. It may also be mentioned that there is no loss to the taxpayer since he can claim the credit of foreign taxes paid by him.

In cases where tax has been withheld in source Country on gross basis, whether ordinary tax credit should be claimed on net income basis/ gross basis

Under the ordinary credit method, the credit is limited to the tax liability on the foreign income in Country of residence. The said amount is known as ‘maximum credit allowable’ for foreign tax credit.

The mechanism to compute the same, given under paragraph 62 of Commentary on Article 23 of the OECD as well as the UN Model Convention is to be as follows:

- apportionment of total tax on total income according to the ratio between the income for which credit is to be given and the total income or
- by applying the tax rate for total income to the income for which credit is to be given

The result in both the cases would be the same as exemption with progression.

Further, paragraph 63 of Commentary on Article 23 of the OECD as well as the UN Model Convention states that “The maximum deduction is normally computed as the tax on net income, i.e. on the income from source Country less allowable deductions (specified or proportional) connected with such income.”

Hence, if the Country of source provides for taxation of income on gross basis, the tax credit in many cases would be lower than the tax effectively paid in the Country of source.

e.g. A Ltd., an Indian resident company receives royalty of INR 400,000 from a foreign Country (Country X) with which India has a DTAA and provides for ordinary credit method. Tax is paid @ 15% on such royalty income in Country X on gross amount [ie.60,000 (15% of 400,000)]. A Ltd. is eligible for deduction of business expenses of INR 280,000 against the royalty income, leaving net taxable income of INR 120,000. India tax on INR 120,000 @ 30.9% is 37,080/-. A Ltd. will be eligible for credit of only INR 37,080 and not INR 60,000 paid in Country X.

The above method of allowing credit was upheld in the case of Arvind Metals & Minerals (P.) Ltd²⁷² by the Kolkata Tribunal and the assessee was allowed only proportionate credit of taxes paid in Thailand against the Indian tax payable in respect of such income and it was held such credit shall not exceed the tax computed as per Indian Income Tax Act and there would be no refund of foreign tax paid.

However, alternative view has been emerging that FTC might lead to refund in cases of tax sparing credit (in cases of deduction not exemption), even though the effective tax rate in India is 'zero'.

In the case of *Blue Star Infotech Ltd. vs. ACIT*²⁷³, the Mumbai ITAT held that tax relief for foreign taxes paid shall be provided in cases of deductions allowed from gross total income since they are deemed to be tax suffered under Tax Sparing method of taxation. Accordingly, a situation may arise where taxes paid in the source Country are refunded in the Country of residence.

Availability of tax credit for DDT paid under the Indian Tax laws mandate the payment of DDT under section 115-O of the Act on any amount declared, distributed or paid by way of dividend. DDT is neither a withholding tax on dividend income nor a tax on the profits of the company from which dividend is declared.

Under the DTAA's, tax credit is typically available for tax on income (i.e. income-tax) and/ or for tax on the profits of the company from which dividend is declared (i.e. Underlying Tax Credit). Therefore, tax credit on DDT is per se not available under the DTAA's. However, in case of India-Hungary DTAA, Underlying Tax Credit (not exceeding 10%) is available to the share-holder for the DDT paid by the company. The relevant clause of the treaty is reproduced below:

"With reference to Article 10:

When the company paying the dividends is a resident of India the tax on distributed profits shall be deemed to be taxed in the hands of the shareholders and it shall not exceed 10 per cent of the gross amount of dividend."

Alternatively, credit for DDT can be availed if Country of residence considers DDT as income-tax or underlying tax as per its domestic law

Also, one may argue that the Indian Tax Law itself considers DDT as "additional income tax" and hence, should be considered for tax credit.

Impact of loss in Country of residency in computing the extent of FTC

A taxpayer may have loss in the Country of residence and income from foreign Country which was subject to tax in that source Country. If the loss in the Country of residence is higher than the foreign income, then tax in India would be nil. Similarly, if loss in India is lower than foreign income then tax in India would be only available on part of foreign income. Consequently, in both the scenarios, the foreign tax credit would only be available on none/part of the foreign income since FTC is restricted to the extent of the tax liability in the home Country on such doubly taxed income.

Mumbai Tribunal in the case of *JCIT v. Digital Equipment India Ltd*²⁷⁴ had examined the issue with reference to Article 25 of the Indo-US DTAA. It was held that no refund shall be allowed to the tax payer since the assessee had loss after set-off of foreign income against the income in the Country of residence (India). The reason cited by the Tribunal was that tax in India was nil

²⁷³ ITA No. 5750, 5751 of 2010 and 8705 of 2011

²⁷⁴ 94 ITD 340

on the doubly taxed income.

Credit for state taxes when treaty exist.

Interestingly, although treaty typically does not deal with state taxes and section 91 which deals with state taxes does not apply when tax treaty exists, before insertion of Rule 128, credit under section 91 for state taxes paid in a foreign country with which India had entered into a tax treaty was allowed/considered in the following cases:

- Wipro Ltd. v. DCIT [2016] 382 ITR 179 (Kar.)²⁷⁵
- DCIT v. Tata Sons Ltd. [2011] 43 SOT 27 (Mumbai ITAT)
- Tata Sons Ltd. v. DCIT [2011] 10 taxmann.com 87 (Mumbai ITAT)

The definition of 'foreign tax' in Rule 128(2) does not cover state taxes, if these taxes are not covered in the tax treaty with India.

An issue may arise is, whether the ratio in these decisions gets diluted on account of Rule 128?

Arguments in favour of credit for state taxes based on pre-Rule 128 judicial precedents	Argument against credit for state taxes based on pre-Rule 128 judicial precedents
One may want to contend that as regards treaty countries, Rule 128 deals only with taxes covered under the treaty [sub-rule (2)(a)] and does not expressly prohibit credit for state taxes paid in a treaty country. In absence of any express prohibition Rule 128 is irrelevant as far as state taxes are concerned. Thus, Rule 128 should not alter the position regarding FTC claim as existing prior to its insertion.	Rule 128 may be treated as a specific provision dealing with FTC and credit can be given only if the requirements of the Rule are satisfied.

'Payable under the Act' v. 'attributable to'

Rule 128(5) uses the words 'tax payable under the Act on such income', as against the words 'attributable to' used in Article 23B(1) of the UN/OECD Model. In case of individuals, this may lead to consideration of minimum slab for each source of income while granting tax credit. Similarly, in case of assessee liable to surcharge, issue may arise as regards availability of credit on surcharge if income from the source of income in the foreign country is below the limits provided for applicability of surcharge. Therefore, application of Rule 128(5) may lead to lesser FTC in some cases.

Carry forward/carry back of excess Foreign Tax Credit

A taxpayer cannot claim full FTC in India if the amount of income tax paid in the foreign Country is higher than the amount of income tax payable in India on that foreign source income. Some

²⁷⁵ It may be noted that special leave petition filed by Revenue against the Karnataka High Court decision has been accepted in the case of CIT v. Wipro Ltd. [2016] 240 Taxman 299 (SC).

Countries allow carry forward/carry back of excess Foreign Tax credit. Such option is not available in India and thus, result in adding to the cost of the taxpayer in India.

Administrative Burden

Some of the other issues could be summarized as below:

- practical issues in submission of form for claiming FTC (i.e. Form 67);
- the computation mechanism in case of difference in the tax assessment year between India and the source Country;
- the mechanism to provide FTC, when the taxpayer is assessed under the Minimum Alternative
- the mechanism to provide FTC, when the taxpayer uses the investment-linked incentives;
- the computation mechanism to compute net income when there are certain common expenses of the business to be apportioned between Indian and overseas operations to compute the “Indian rate of tax” for overseas income and where the computations are different.
- in real life situations, the assessee may have more than one source of income in and out of India. Some sources may result in profits and some in losses. Rule 128 does not give any guidance as regards set off of losses. This aspect needs to be analysed in greater detail.

23.11 Some recent rulings

Suzlon Energy Ltd (2017) 188 TTJ 278 (Ahd ITAT)

The Ahmedabad Tribunal directed the Revenue to examine whether FTC can be granted against assessee’s MAT liability while noting that the treaty does not distinguish between a normal tax liability and a MAT liability; However, the ITAT cautioned about impact of subsequent MAT credit under section 115JAA stating that in case FTC is granted tax credit under the treaty and the corresponding tax payment in India, even though partially, is again granted credit in the subsequent year in the assessment of income, there could indeed be a double credit for the same payment of taxes.

Sunil Shinde (2017) 85 taxmann.com 297 (Bng ITAT)

The Bangalore ITAT ruled that the Federal and State taxes withheld in USA should not be added back while computing income taxable in India. The assessee had argued that section 198 which deems the tax deducted at source in accordance with the provisions of the Indian Income-tax Act as income, is not applicable to taxes withheld abroad and withholding of taxes is diversion by overriding title. However, since the assessee was ordinarily resident in India, the Revenue had held that by virtue of section 5(1)(c), the Federal taxes and State income-taxes withheld in the USA (though considered as arising/accruing outside India), was part of assessee’s taxable salary income in India. Rejecting the Revenue’s stand, the ITAT held that for clause (c) of

section 5(1), grossing up of income is not required and only net income after TDS is to be taxed in India but for granting the benefit of Federal tax withheld in USA, the same has to be quantified as per Article 25 of Indo US DTAA. It hence remanded the matter to the Assessing Officer to quantify FTC under Article 25 stating that FTC cannot exceed that part of the income-tax (as computed before the deduction is given) which is attributable to the income which may be taxed in the USA.

Texas Instruments (India) (P.) Ltd.(2018) 301 CTR 1 (AAR), Hewlett Packard India Software Operation (P.) Ltd. (2018) 91 taxmann.com 473 (AAR)

The AAR held that by virtue of Article 25 and Article 23 of the USA and the Germany DTAA respectively, the assignees are entitled to FTC for the taxes deducted overseas, when tax is withheld in India under section 192 of the ITA.

Another issue that requires consideration is whether unutilized FTC for which relief has not been allowed under section 91, is a tax deductible expense. While some court rulings [interalia Mastek Ltd (2013) 151 TTJ 484 (Ahd ITAT), Reliance Infrastructure Ltd. (2017) 390 ITR 271 (Bom HC)] have upheld deductibility, the larger view [Smith Kline & French (India) Ltd (1996) 219 ITR 581 (SC), Lubrizol India Ltd (1991) 187 ITR 25 (Bom HC), Tata Sons Ltd (2011) 43 SOT 27 (Mum ITAT), Elitecore Technologies (P) Ltd (2017) 187 TTJ 1 (Ahd ITAT)] is that deduction under section 37(1) cannot be allowed in respect of taxes paid abroad as the same will be hit by the disabling provisions of section 40(a)(ii) of the ITA.

In Hertz Software India (P.) Ltd. v DCIT [2022] 139 taxmann.com 448 (Bangalore - Trib., assessee did not file Form 67 before the filing of return of income, but submitted during assessment proceedings, which was not accepted by AO. Provisions of Rule 128 were held to be not mandatory rather as directory in nature. Also since DTAA overrides the provisions of the Act and Rules, it was held that FTC cannot be denied to the assessee.

The same was also upheld in Ms. Brinda RamaKrishna v. ITO [2022] 135 taxmann.com 358 (Bangalore - Trib.).

24. Article 24 – Non-discrimination

24.1 General

- All the DTAA's entered into by India have an article on non – discrimination. Through this article the contracting parties agree to give a fair deal in the matter of taxation between residents and non – residents. Article 24 ensures non – discrimination for the purposes of taxation of Nationals & Residents of the other contracting state. This Article applies to “taxes of every kind and description” and not just taxes covered under Article 2 of the treaty.
- Further this Article, is only a special provision and not a ‘savings’ provision, and hence cannot, in our view have any overriding effect on the other provisions of the concerned DTAA. This Article reflects the expression of concern by a Contracting State to ensure that there is a fair treatment given to its national and/or residents in the matter of taxation

of income of such persons in the other Contracting State. In this context if the two Contracting States have agreed to differential treatment as contained in the other provisions of the DTAA, in our view, this Article cannot override such specific provisions i.e., if the two States have agreed to a specific manner of determination or computation of income chargeable to tax, then the Article on non – discrimination cannot be applied so as to negate this agreement. The interpretation of this Article must be consistent with the preamble, the wordings of the Article and the provisions contained in the other Articles of a DTAA.

- This article deals with the elimination of tax discrimination in certain precise circumstances. All tax systems incorporate legitimate distinctions based, for example on differences in liability to tax or ability to pay. The non – discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions.
- Likewise, the provisions of the Article cannot be interpreted as to require most favoured – nation treatment. Where a State has concluded a bilateral or multilateral agreement which affords tax benefits to nationals or residents of the other Contracting State (s) party to that agreement, nationals or residents of third State that is not a Contracting State of the treaty may not claim these benefits by reason of a similar non-discrimination provision in the double taxation convention between the third State and the first – mentioned state. As tax conventions are based on the principle of reciprocity a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State party to that agreement by reason of the specific economic relationship between those Contracting States may not be extended to a resident or national of a third State under the non - discrimination provisions of the tax convention between the first State and the third State.
- The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g., nationality in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wordings to achieve that result (e.g., “in the same circumstances” in paragraphs 1 and 2; “carrying on the same activities” in paragraph 3; “similar enterprises” in paragraph 5). Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, it is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned or controlled by non – residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents.
- Further the domestic laws do have different provisions applicable to residents and non-residents. Some of the provisions applicable to non-residents are based on the need to reduce unnecessary litigation viz. determination of chargeable income on the gross basis but in a concessional manner or admissibility of expenses to avoid detailed examination of records not available in the country concerned (head office expenses) or ensuring recovery of tax without resorting to litigation outside the country by providing for deduction

of tax at source, grant of incentives for residents to encourage indigenous activity etc., To what extent such provisions of the domestic law will be considered as discriminatory and hence violate the provisions of a non – discrimination article in a DTAA is a moot point.

24.2 UN Model Convention – Article 24

- Article 24 of the Model Conventions deal with non – discrimination under Chapter titled “Special Provisions” as distinct from the earlier Chapter titled “Taxation of Income”. The word “special” appears to have been used to differentiate between distribution of taxing rights and provisions which are ‘general’ in nature and dealing with subjects such as non – discrimination, mutual agreement procedure, exchange of information, assistance for tax recovery etc., Article 24 does not begin with the words “notwithstanding the other provisions contained in the agreement” or couched in other similar words to indicate the overriding nature of the Article.
- It provides for non- discrimination on grounds of nationality (Paragraph 1), stateless persons resident in one of the Contracting States – other than US MC (Paragraph 2), permanent establishment of an enterprise of a Contracting State (Paragraph 3), admissibility of interest, royalty and other disbursements paid by an enterprise to a resident of the other Contracting State (Paragraph 4) and enterprises which are wholly or partly owned or controlled directly or indirectly by one or more residents of a Contracting State (Paragraph 5). The non-discrimination must relate to any taxation or any requirement connected therewith and covers all taxes.
- By this Article it is intended to achieve parity between a national and a foreigner in matters of taxation. This requirement of treating a foreigner on par with the national is extended to enterprises of a foreigner and enterprise of a national as also to enterprise controlled – wholly or partly, and directly or indirectly by one or more residents of one of the contracting states. The terms “resident”, ‘National’, ‘enterprise of a contracting state’, ‘enterprise of the other contracting state’ are defined in Article 3 of the Model convention.

24.2.1 Article 24 – Non-Discrimination

- (1) Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.
- (2) Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.

- (3) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
- (4) Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
- (5) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
- (6) The provisions of this Article shall, notwithstanding the provisions of Article , apply to taxes of every kind and description”
- a. Paragraph (1) of Article 24 Provides that:**
- Nationals of a Contracting State – notwithstanding being a non – resident of one or both the Contracting States.
 - Shall not be subjected to **any** taxation **or**
 - **any** requirements connected therewith
 - which is *other than* the taxation **and** connected requirements to which nationals of the other State in the same circumstances are or may be subjected – in particular with respect to residence or
 - which is *more burdensome* than the taxation **and** connected requirements to which nationals of the other State in the **same circumstances** are or may be subjected – in particular with respect to residence.
- (1) The paragraph establishes the principle that for purpose of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in other Contracting State than

nationals of the latter State in the same circumstances.

- (2) Article 24 (1) provides for the non – discrimination of legal and natural persons on the grounds of nationality. It applies to taxation and related requirements imposed in a Contracting State on nationals of the other Contracting State. Unlike other treaty Articles, the provision overrides Article 1 and applies to the nationals of the other Contracting State, even if they are non-residents of one or both states.
- (3) The nationals of the other State must be treated for tax purpose on par with the nationals of the Contracting State. Their tax treatment must not be other or more burdensome (i.e., must be the same) than that imposed under the domestic tax law on its own nationals in the same circumstances. The comparable tax treatment includes the basis of tax charge, the method of assessment, the tax rate and the compliance formalities under the domestic law, but does not extend to the benefits under the various double tax treaties. The comparison should be based on the tax treatment of a “notional” national to check if there is any discrimination. The term “other or more burdensome” refers to both the form and substance of taxation. The taxes levied cannot be unreasonable, irrelevant or arbitrary. Moreover, the tax discrimination must not be justified by non – tax considerations.
- (4) The text of paragraph 1 provides that the application of this paragraph is not restricted by Article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one of them. In other words, all nationals of a Contracting State are entitled to invoke the benefits of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third state.
- (5) Under this paragraph, “in the same circumstances, in particular with respect to residence” implies that persons who are residents of the same State should not be treated differently for tax purposes solely due to their nationality. The Article 2 forbids tax discrimination of residents when based on nationality only, but it does not prohibit discrimination against foreigners for other reasons. Non-resident foreigners are not in the same circumstances as resident nationals and foreigners. This paragraph, therefore, does not entitle them to claim the same tax treatment as given to residents of the taxing State. However, it does not ensure that they are not treated differently from non-residents nationals of that State.
- (6) The expression “in the same circumstances” refers to taxpayers (individuals, legal persons, partnership and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact. The expression “in particular with respect to residence” makes clear that the residence of the taxpayer is one of the factors that are relevant in determining whether taxpayers are placed in similar circumstances. The expression “in the same circumstances” would be sufficient by itself to establish that a taxpayer who is a resident of a Contracting State and one who is not a resident of that State are not in the same circumstances.

- (7) The expression 'connected requirement therewith' would refer to the procedural aspects of taxation such as filing of returns, time limit for such filing, payment of taxes in advance and the like. One has to compare both taxation and the requirements connected with the taxation and not just the requirements connected with the taxation. In this regard note the use of conjunction 'and' between 'the taxation' and 'requirements connected therewith' in the second half of the sentence while in the first half it is mentioned as 'any taxation or any requirement connected therewith'.
- (8) In applying paragraph 1, therefore, the underlying question is whether two persons who are residents of the same State are being treated differently solely by reason of having a different nationality. Consequently if a Contracting State, in giving relief from taxation on account of family responsibility, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its nationals who reside in the other State. Similarly, paragraph 1 does not apply where a national of a Contracting State (State R) who is also a resident of State R is taxed less favourably in the other Contracting State (State S) than a national of State S residing in a third State (for instance, as a result of the application of provisions aimed at discouraging the use of tax havens) as the two persons are not in the same circumstances with respect to their residence.
- (9) Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.
- (10) Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.
- (11) To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporation carrying on gainful undertaking. To the extent that these can be regarded as being on the same footing as private business undertakings, the provisions of paragraph 1 will apply to them.
- (12) As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.
- (13) Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more

burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed in accordance with Article 7, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

- (14) Subject to the foregoing observation, the words “..... shall not be subjected... to any taxation or any requirement connected therewith which is other or more burdensome...” mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with the taxation (returns, payment prescribed times, etc) must not be more onerous for foreigners than for nationals.
- (15) In view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under paragraph 1. This result is achieved through the definition of the term “national” in subparagraph (f) of paragraph 1 of Article 3.
- (16) By virtue of that definition, in the case of a legal person such as a company “national of a Contracting State” means a legal person “deriving its status as such from the laws in force in that Contracting State”. A company will usually derive its status as such from the laws in force in the State in which it has been incorporated or registered. Under the domestic law of many countries, however, incorporation or registration constitutes the criterion, or one of the criteria, to determine the residence of companies for the purposes of Article 4. Since paragraph 1 of Article 24 prevents different treatment based on nationality but only with respect to persons or entities “in the same circumstances, in particular with respect to residence”, it is therefore important to distinguish, for purposes of that paragraph, a different treatment that is solely based on nationality from a different treatment that relates to other circumstances and, in particular, residence. As explained above, paragraph 1 only prohibits discrimination based on a different nationality and requires that all other relevant factors, including the residence of the entity, be the same. The different treatment of residents and non-residents is a crucial feature of domestic tax systems, and of tax treaties; when Article 24 is read in the context of the other Articles of the Conventions, most of which provide for a different treatment of residents and non-residents, it is clear that two companies that are not residents of the same state for purpose of the Convention (under the rules of Article 4) are usually not in the same

circumstances for purposes of paragraph 1.

(17) The following example illustrates the principle:-

Under the domestic income tax law of state A, Companies incorporated in that State are residents thereof and companies incorporated abroad are non-residents. The State A – State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Paragraph 1 does not extend that treatment to dividends paid to a company incorporated in State B. Even if a company incorporated in State A and a company incorporated in State B that receives such dividends are treated differently, these companies are not in the same circumstances with regards to their residence and residence is a relevant factor in this case.

The OECD commentary on 2008 version of the MC as quoted by the UN commentary has observed that this article cannot be interpreted as to require “most favoured – nation treatment” As tax conventions are based on the principle of reciprocity, a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State, party to that agreement by reason of the specific economic relationship between those Contracting States may not be extended to a resident or national of a third State, under the non-discrimination provision of the tax convention between the first state and the third state”. India has expressed the right to insert such a clause in its DTAA to this effect.

b. Paragraph (2) of Article 24 Provides that:

Paragraph (2) of Article 24 deals with state less persons who are residents of a Contracting State.

As per paragraph 1 of Article 1 of convention of 28th September 1954, which defines a stateless person as “a person who is not considered as a ‘national’ by any State under the operations of its law”. A stateless person in either contracting state can invoke the non-discrimination provision.

This paragraph does not find a place in most of the DTAA's entered into by India, possibly because the arrangements deal with ‘Resident of a Contracting State’ and irrespective of whether a ‘resident’ is a ‘national’ or ‘stateless’. The non-discrimination clause contained in Paragraph (1) would apply to all cases.

c. Paragraph (3) of Article 24 Provides that:

1. This Paragraph deals with a ‘permanent establishment’ (PE) that an ‘enterprise of a Contracting State’ has in the other ‘Contracting State’. By the definition of the expression ‘enterprise of a Contracting State’ as contained in Article 3 it applies to only enterprise

carried on by a resident of the Contracting State. Hence this paragraph deals with non-discrimination of a 'resident' of a Contracting State in respect of the 'enterprise' carried on through a PE by such person in the other Contracting State – viz. the Source State.

2. The Paragraph provides that a PE of the Residence State shall not be treated 'less favourably' in taxation matters by the Source State as compared with an 'enterprise' of the Source State. Exception is provided in case of grant to residents of any personal allowance, reliefs and reductions on account of civil status or family responsibilities eg. marriage allowance, deduction on account of education of children etc.,
3. Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State. Taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities.
4. By the terms of the first sentence of paragraph 3, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishment as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on business activities, and especially taxes on business profits.
5. However, the second sentence of paragraph 3 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income' taxable in the other State.
6. It is also clear that, for purposes of paragraph 3, the tax treatment in one Contracting State of the permanent establishment of an enterprise of the other Contracting State should be compared to that, of an enterprise of the first-mentioned State as a legal structure that is similar to that of the enterprise to which the permanent establishment belongs. Thus, for example, paragraph 3 does not require a State to apply to the profits of the permanent establishment of an enterprise carried on by a non-resident individual the same rate of tax as is applicable to an enterprise of that State that is carried on by a resident company.
7. Similar, regulated and unregulated activities would generally not constitute the "same activities" for the purposes of paragraph 3. Thus, for instance, paragraph 3 would not

require that the taxation on a permanent establishment whose activities include the borrowing and lending of money but which is not registered as a bank be not less favourably levied than that of domestic banks since the permanent establishment does not carry on the same activities. Another example would be that of activities carried on by a State or its public bodies, which since they are controlled by the State, could not be considered, for the purposes of paragraph 3, to be similar to activities that an enterprise of the other State performs through a permanent establishment.

8. As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

(i) Assessment of tax

With regards to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

- (a) Permanent establishment must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorized by the taxation law to be deducted from taxable profits. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprise.
- (b) Permanent establishment must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ("wholesale" writing down, accelerated depreciation, etc.) As regards reserves, it should be noted that these are sometimes authorized for purposes other than the offsetting – in accordance with commercial accounting principles – of depreciation on assets, expenses or losses which have not yet occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit, provisions or "reserves" for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprise with respect to their permanent establishments situated in the State concerned, insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State.
- (c) Permanent establishments should also have the option that is available in most countries

to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g., 5 years). It is hardly necessary to specify that in the case of permanent establishment it is the loss on their own business activities which will qualify for such carry forward.

- (d) Permanent establishment should further have the same rules as applied to resident enterprises, with regard to the taxation of capital gains realized on the alienation of assets, whether during or on the cessation of business.
1. As clearly stated in subparagraph (c) above, the equal treatment principle of paragraph 3 only applies to the taxation of the permanent establishments own activities; that principle, therefore, is restricted to a comparison between the rules governing the taxation of the permanent establishment's own activities and those applicable to similar business activities carried on by an independent resident enterprise.
 2. Also, it is clear that the application of transfer pricing rules based on the arm's length standard in the case of transfers from a permanent establishment to its head office (or vice versa) cannot be considered to be a violation of paragraph 3 even if such rules do not apply to transfers within an enterprise of the Contracting State where the permanent establishment is located. Indeed, the application of the arm's length standard to the determination of the profits attributable to a permanent establishment is mandated by paragraph 2 of Article 7 and that paragraph forms part of the context in which paragraph 3 of Article 24 must be read; also, since Article 9 would authorize the application of the arm's length standard to a transfer between a domestic enterprise and a foreign related enterprise, one cannot consider that its application in the case of a permanent establishments results in a less favourable taxation than that levied on an enterprise of the Contracting State where the permanent establishment is located.
 3. It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.
 4. Also, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.
 5. Finally, the provisions of paragraph 3 should not be construed as obliging a State which accords special taxation privileges to non-profit institutions whose activities are performed for purposes of public benefit that are specific to that State, to extend the same privileges to permanent establishments of similar institutions of the other

State whose activities are not exclusively for the first—mentioned State's public benefit.

(ii) Special treatment of dividends received in respect of holdings owned by permanent establishments

1. In many countries special rules exist for the taxation of dividends distributed between companies (parent company-subsidiary treatment, the Schachtelprivileg, the rule non *bis* in *idem*). The question arises whether such treatment should, by effect of the provisions of paragraph 3, also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.
2. On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle, profits tax should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the, head office of the parent company is situated to give relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The State of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e. for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.
3. Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward relates to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment

to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends, its extension to permanent establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 3 does not entail any obligation to extend such treatment to permanent establishments argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

4. The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,
 - reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;
 - or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;
 - or simple reasons of practical convenience, in line with the present tendency towards decentralisation of management functions in large enterprises.
5. In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 3. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.
6. A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5% or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions of paragraphs 2 and 4 of Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent

establishments of companies which are residents of State B in the same way as if they are received directly i.e. by the head offices of the latter companies, viz., at the rate of:

- 5 per cent in the case of a holding of at least 25 per cent;
- 15 per cent in all other cases.

7. Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned, to levy a withholding tax on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

(iii) Structure and rate of tax

1. In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 3 raise, with regard to the rate applicable in the case of permanent establishments, some specific issues related to the fact that the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.
2. When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way. States that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.
3. When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 3 are not observed only if the minimum rate is higher.
4. However, even if the profits of the whole enterprise to which the permanent establishment belongs are taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the separate and independent enterprise, according to which the profits of the permanent establishment must be determined under paragraph 2 of Article 7. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a separate and independent enterprise, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent

establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment, leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

5. Since a permanent establishment, by its very nature, does not distribute dividends, the tax treatment of distributions made by the enterprise to which the permanent establishment belongs is therefore outside the scope of paragraph 3. Paragraph 3 is restricted to the taxation of the profits from the activities of the permanent establishment itself and does not extend to the taxation of the enterprise as a whole. This is confirmed by the second sentence of the paragraph, which confirms that tax aspects related to the taxpayer that owns the permanent establishment, such as personal allowances and deductions, are outside the scope of the paragraph. Thus, issues related to various systems for the integration of the corporate and shareholder's taxes (e.g. advance corporate tax, *précomptemobilier*, computation of franked income and related dividend tax credits) are outside the scope of the paragraph.
6. In some States, the profits of a permanent establishment of an enterprise of another Contracting State are taxed at a higher rate than the profits of enterprises of that State. This additional tax, sometimes referred to as a "branch tax", may be explained by the fact that if a subsidiary of the foreign enterprise earned the same profits as the permanent establishment and subsequently distributed these profits as a dividend, an additional tax would be levied on these dividends in accordance with paragraph 2 of Article 10. Where such tax is simply expressed as an additional tax payable on the profits of the permanent establishment, it must be considered as a tax levied on the profits of the activities of the permanent establishment itself and not as a tax on the enterprise in its capacity as owner of the permanent establishment. Such a tax would therefore be contrary to paragraph 3.
7. That situation must, however, be distinguished from that of a tax that would be imposed on amounts deducted, for instance as interest, in computing the profits of a permanent establishments (e.g. "branch level interest tax"); in that case, the tax would not be levied on the permanent establishment itself but, rather, on the enterprise to which the interest is considered to be paid and would therefore be outside the scope of paragraph 3 (depending on the circumstances, however, other provisions, such as those of Articles 7 and 11, may be relevant in determining whether such a tax is allowed by the Convention; see the last sentence of paragraph 4).
8. Explanation 1 to section 90 of the Act provides that the charge of tax in respect of foreign company at a rate higher than the rate applicable to a domestic company shall not be regarded as a less favourable charge or levy of tax. Judicial precedents²⁷⁶ have held that

²⁷⁶Chohung Bank (2006) 6 SOT 144 (Mum ITAT), Delmas France (2014) 67 SOT 336 (Mum ITAT)

foreign companies being charged a higher rate of tax cannot be held to be covered by the provisions ensuring non-discrimination under the tax treaty.

(iv) Withholding tax on dividends, interest and royalties received by a permanent establishment

1. When permanent establishments receive dividends, interest, or royalties such income, by virtue of paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12, respectively, comes under the provisions of Article 7 and consequently — subject to the observations made under paragraph II as regards dividends received on holdings of permanent establishment — falls to be included in the taxable profits of such permanent establishments.
2. According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12, these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means — and this is the generally accepted interpretation — that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.
3. While this approach does not create any problems with regard to the provisions of paragraph 3 of Article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non-residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.
4. In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 3 that for the purpose of taxing the income which is derived from their activity, or which is normally connected with it — as is recognized to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph 3 of Article 12 — permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.
5. In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

(v) Credit for foreign tax

1. In a related context, when foreign income is included in the profits attributable to a permanent establishment, it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.
2. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B), credit for tax levied in a third State (C) can

be allowed only by virtue of a convention, then the more general question arises as to the extension to permanent establishments of the benefit of credit provisions included in tax conventions concluded with third States. Whilst the permanent establishment is not itself a person and is therefore not entitled to the benefits of these tax conventions, this issue is relevant to the taxation on the permanent establishment. This question is examined below in the particular case of dividends and interest.

(vi) Extension to permanent establishments of the benefit of the credit provisions of double taxation conventions concluded with third States

1. When the permanent establishment in a Contracting State of a resident enterprise of another Contracting State receives dividends or interest from a third State, then the question arises as to whether and to what extent the Contracting State in which the permanent establishment is situated should credit the tax that cannot be recovered from the third State.
2. There is agreement that double taxation arises in these situations and that some method of relief should be found. The majority of member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 3. States that cannot give credit in such a way or that wish to clarify the situation may wish to supplement the provision in their convention with the Contracting State in which the enterprise is resident by wording that allows the State in which the permanent establishment is situated to credit the tax liability in the State in which the income originates to an amount that does not exceed the amount that resident enterprises in the Contracting State in which the permanent establishment is situated can claim on the basis of the Contracting State's convention with the third State. If the tax that cannot be recovered under the convention between the third State and the State of residence of the enterprise which has a permanent establishment in the other Contracting State is lower than that under the convention between the third State and the Contracting State in which the permanent establishment is situated, then only the lower tax collected in the third State shall be credited. This result would be achieved by adding the following words after the first sentence of paragraph 3:

When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt-claim in respect of which the dividends or interest are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first-mentioned State can claim under that State's convention on income and capital with the third State.

If the convention also provides for other categories of income that may be taxed in the State in which they arise and for which credit should be given (e.g. royalties, in some conventions), the above provision should be amended to also cover these.

3. Where a permanent establishment situated in a Contracting State of an enterprise resident of another Contracting State (the State of residence) receives dividends, interest or royalties from a third State (the State of source) and, according to the procedure agreed to between the State of residence and the State of source, a certificate of domicile is requested by the State of source for the application of the withholding tax at the rate provided for in the convention between the State of source and the State of residence, this certificate must be issued by the latter State. While this procedure may be useful where the State of residence employs the credit method, it seems to serve no purposes where that State uses the exemption method as the income from the third State is not liable to tax in the State of residence of the enterprise. On the other hand, the State in which the permanent establishment is located could benefit from being involved in the certification procedure as this procedure would provide useful information for audit purposes. Another question that arises with triangular cases is that of abuses. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.
 4. In addition to the typical triangular case considered here, other triangular cases arise, particularly that in which the State of the enterprise is also the State from which the income ascribable to the permanent establishment in the other State originates. States can settle these matters in bilateral negotiations.
- d. Paragraph (4) of Article 24 Provides that:**
1. This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restrictions when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non - resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.
 2. This Paragraph provides that no discrimination be made in regard to deduction of interest, royalties and other disbursements by a resident of a Contracting State (Source State) to

a resident of the other Contracting State (Residence State) while determining taxable profits of the resident of the Source State. This paragraph provides that such expenses must be deductible under the same conditions as if they had been paid by such payer to another resident of the Source State.

3. Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalization insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.
4. The Paragraph also mentions that the above requirement would apply equally to debts for the purposes of determining the taxable capital. This part may not be relevant for India as there is no tax on capital. The paragraph mentions 'taxable capital' and not for determining 'taxable profits' and hence deductibility of 'bad debts' may not be covered under this paragraph.
5. Also paragraph 4 does not prohibit additional information requirements with respect to payments made to non – residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non – residents.
6. "It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes".
7. The expression "other disbursements" is very wide and would, "include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expenses".

On the interpretation of this Paragraph one may refer to the decision in Daimler Chrysler India Private Ltd vs. DCIT Circle 8, Pune (2009) 29 SOT 202 (Pune) wherein the Tribunal had quoted the following from Mr. Philip Baker's book on "Double Taxation Conventions and International Tax Law", A manual on the OECD Model tax convention on Income and on capital, 1992, Second Edn. at pp. 396 to 397.

"Article 24 (4): Deduction of interest, royalties and other disbursements Article 24(4) is not concerned with the discriminatory treatment of nationals, etc. of one State in the other Contracting State, but the treatment of enterprises of a Contracting State under the tax law of that State. Subject to the position where a special relationship exists between the enterprise and the recipient, interest, royalties and other disbursements paid to a resident of the other Contracting State should be deductible to the same extent that they would be deductible if paid to a resident of the same State. Thus this prevents the indirect discrimination which would arise if the sums were not deductible. A similar provision is included in the article relating to the deduction of debts owed to residents of the other Contracting State in determining the taxable capital of the enterprise.

8. The Finance Act, 2017 has inserted a new section 94B in line with BEPS Action Item 4 (“Limiting Base Erosion Involving Interest Deductions and Other Financial Payments”) which provides that where an Indian company or an Indian PE of a foreign company, being the borrower incurs any expenditure by way of interest or of similar nature exceeding one crore rupees which is deductible in computing income chargeable under the head "Profits and gains of business or profession" in respect of any debt issued by a non-resident, being an associated enterprise of such borrower, the deduction shall be limited to 30% of EBITDA(earnings before interest, taxes, depreciation and amortisation) or interest paid, whichever is less.

For the purpose of determining debt issued by the non-resident, the funds borrowed from a non-associated lender shall also be deemed to be borrowed from an associated enterprise if such borrowing is based on an implicit or explicit guarantee of an associated enterprise.

The Finance Minister’s budget speech stated that the provision is being introduced in order to address the issue of thin capitalisation. It would hence need to be examined whether denial of deduction for interest paid to a non-resident in terms of section 94B, would amount to discrimination against such non-resident, necessitating claim for benefit of Article 24(4).

e. Paragraph (5) of Article 24 Provides that:

1. This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. The provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.
2. Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefit of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g., rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership). For example, if the domestic tax law of one State allows a resident company to consolidate its income with that of a resident parent company, paragraph 5 cannot have the effect to force the State to allow such consolidation between a resident company and a non-resident parent company. This would require comparing the combined treatment of a resident enterprise and the non-resident that owns its capital with that of a resident enterprise of the same State and the resident that owns its capital, something that clearly goes beyond the taxation of the resident enterprise alone.
3. Also, because paragraph 5 is aimed at ensuring that all resident companies are treated

equally regardless of who owns or controls their capital and does not seek to ensure that distributions to residents and non – residents are treated in the same way it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the Company is owned controlled by non – residents but, rather, on the fact that dividends paid to non – residents are taxed differently.

4. In the case of transfer pricing enquiries, almost all member countries consider that the request for additional information and the reversal of the burden of proof in transfer pricing cases do not amount to discrimination under this Article. Moreover, it does not prohibit thin capitalization rules under arm's length principle.

f. Paragraph (6) of Article 24 provides that:

This Paragraph does not provide for any non – discrimination requirement but provides that the protection against non – discrimination contained in this Article shall apply to taxes of every kind and description, notwithstanding the definition of 'taxes' contained in Article 2.

24.3. Practical Issues

24.3.1 Reciprocity in Agreements

As essential part of the agreement is non – discrimination based on reciprocity. The main purpose of the non-discrimination clause is to treat local residents and residents of the other country equally. Non-residents of either country, being nationals of both the participating countries may also be expected to be treated in the same way. Permanent establishments of an enterprise, whether solely belonging to the resident of the other country or partly belonging to such resident as in the case of joint venture are also required to be treated alike. The participant countries would require that their residents or citizens are treated on par with the nationals of the other State with which they have agreements. UN model would provide that the tax on their residents or citizens shall not be more burdensome than what is placed on the residents and nationals of the other State. UN model further makes it clear that, even where it is possible that the relief claimed under double tax avoidance agreement may relate to a person, who is not a resident in both the countries, there should be no discrimination in respect of the same income on which double tax avoidance agreement is applicable. When it is meant that the tax shall not be more burdensome than the tax on the nationals of that State, the nationals would not only include individuals or companies but also legal entities incorporated under its laws. Permanent establishment of an enterprise in one State should also be similarly not to be treated less favourably in the State than the enterprises established by its own nationals. It, however, does not mean that any special allowance, relief or reduction dependent upon 'civil status or family responsibilities' should be available to non-residents or residents of the other State. Non-discrimination is ensured in computation of income as well by providing that where any deduction is available under the local law in computation of income, such deduction should not

be refused in the hands of the non-residents or residents of the other State including permanent establishment of the enterprise of other State. Similarly where an enterprise is carried on by a resident of the other State or by way of participation in such enterprise along with local residents, there should be no discrimination against such entities as well. Non-discrimination clause applies not only to the tax covered by the agreement but also to all classes and every kind of description. The clauses extend to taxes not covered by the agreement as well, because non-discrimination is an important aspect of such friendly agreements to encourage inter-State trade. OECD model also is in *pan materia* with UN Model in this regard.

According to Indian law, if tax is not deducted from a payment to a non-resident, such payment is to be disallowed under section 40(a)(i). It is to be examined, whether this provision is in conformity with the provisions of the Double Taxation Avoidance Agreements. The issue was the subject matter of adjudication in *Dy. CIT v. Gupta Overseas* [2014] 30 ITR (Trib) 738 (Agra) in interpreting Double Taxation Avoidance Agreements with Spain, Ireland, Denmark, Austria, Belgium, U.K. and Italy. Article 24 of the Agreements in broad terms state that there should be no discrimination on grounds of reason of nationality, 'where circumstances are same and conditions are similar'. This is the condition in Agreements with Spain, Ireland, Denmark and Austria, but not in the Agreements with Belgium, U.K. and Italy. The Tribunal observed that the Protocol to the India-Spain tax treaty in fact provides that interest, royalty or FTS payable by an Indian resident to a Spanish resident shall not be deductible unless TDS under the Indian law has been paid. It further observed that the expression 'in the same circumstances' would be sufficient by itself to establish that a taxpayer who is a resident of a Contracting State and one who is not a resident of that State are not in the same circumstances. The ITAT held that a differentiation in treatment due to residential status cannot be covered by the scope of Article 24(1) as such a differentiation is not due to the nationality factor. On this basis, the disallowance relating to payments to residents of Spain, Ireland, Denmark and Australia was held to be outside the scope of Article 24 and the disallowance related to payments to residents of Belgium, U.K. and Italy was held to be discriminatory following *Daimler Chrysler India Pvt. Ltd. v. Dy. CIT* [2009] 120 TTJ (Pune) 803 and *Boake Allen Ltd. V. Her Majesty's Revenue and Customs* [2007] UKHL 25 (HL)., The decision in *Herbalife International India Pvt. Ltd. v. Asst. CIT* [2006] 103 TTJ (Del) 78 was distinguished by the ITAT on the basis that the India – USA tax treaty has a specific deduction non-discrimination provision, which was not there in the case before it.

In *Mitsubishi Corporation India (P) Ltd*²⁷⁷, the Delhi ITAT held that Article 24 read with Article 9 of the Indo Japan DTAA prohibits deletion of enhancement of income due to transfer pricing adjustment, but permits deletion of enhancement of income due to disallowance under section 40(a)(i) of the Act.

24.3.2 Denial of concessions to non-residents amount to discrimination?

Another interesting aspect of non-discrimination clause in double tax avoidance agreement is the grant of benefit of most favoured nations to some countries; Does it amount to discrimination with others? Is it not an indirect method of bypassing non-discrimination clause? This is a

²⁷⁷(2015) 171 TTJ 417 (Del ITAT)

discrimination not always by a positive discrimination in domestic law but by differential treatment of the same kind of income differently in different agreements. Such a situation is not at all uncommon because agreements are often matters of bargain between countries with differential rates and differential methods of relief. But the issue also arises not merely because of such variation, but also because of a larger concession to a few countries treated as most favoured nation.

In the agreement between Germany and Italy, a Dutch national working for a German company was more liable to tax in Italy for the work done by the German company in Italy. Since he was a Dutch national and not a German national, the benefit of treaty with Germany was found inapplicable. He would have been eligible, if he had been a German national. A claim was made successfully on the basis of non-discrimination clause. As pointed out by Philip Baker, it is an unusual case and may not be extended in other cases in similar situations. It is a triangular case, where relief was sought on the terms of an agreement, which is not applicable at all.

In respect of third party agreement especially in shipping line, such problems arise. Here a ship flies the Flag of one country, having been incorporated in a different country and earns income in a third State. This has given rise to controversies as discussed in the Chapter dealing with shipping cases. Commentaries would indicate the need for clarity in this Article as the basic requirement of non-discrimination should be reflected in the letter and spirit in such agreements. But at the same time, the commentaries would point out the difficulty in giving effect to the same in view of the disparities between the systems of taxation and adoption of different criteria for residential status. Reservations expressed on the UN model agreement by different countries would also point out differing perceptions of the Member-States as to the scope of such agreement. This is again another area where agreement not in the language of the article but its practical application would appear to be of paramount importance, if the agreements are to serve their purpose.

Where the taxable income has been determined under section 44BB — non-discriminatory clause under Article 25 of DTAA does not apply. It was so held in *Micoperi S. p. A. Milano v. Dy. CIT* (2002) 82 ITD 369 (Mum).

24.3.3 Parallels for non-discrimination in domestic law

The goal of non-discrimination as between States is an issue even in a Federal Constitution. Part-XIII of the Indian Constitution would incorporate this principle in Articles 301 to 307 with the objective of ensuring that there is economic unity of India. Article 301 assures free intercourse of trade and commerce throughout the territory of India. Courts have held that freedom of movement of goods as between States is assured by this Article, though such freedom can be regulated as by traffic regulations, licensing of vehicles, minimum wage legislations, health regulations etc.

Sales-tax concession for encouraging a local industry or imposition of a higher rate of sales-tax from that in the neighbouring State had not been held to be violative of the Constitutional right in *Atiabari Tea Co. Ltd. v. State of Assam* (1961) 1 SCR 809, where it was pointed out that adoption of remedial measures intended solely for the protection of regional interest is not

violative of this Article, but if it is done “without due regard to their effect and economy of the nation as a whole, it may well be treated as violative”. Power to grant exemption or concessions in public interest is a normal power and cannot be questioned in view of possible apprehension of discrimination. It was so held in *State of Madras v. N. K. Nataraja Mudaliar* [AIR 1969 SC 147]. Similarly, a mere increase in rate which may have the effect of making the goods of the neighbouring State cheaper could not be faulted with reference to Article 301 as held in *Vrijalal v. State of MP* [AIR 1986 SC 1085] of late.

While the States are moving towards uniform rate of sales tax, the Courts have taken a uniform view that in respect of movement of goods, there can be no restriction since no geographical barriers could be imposed within the country. While power to restrict in public interest is given to Parliament under Article 302, bar against preferences or discrimination as between one State and another applies both for Parliament and the State Legislature under Article 303. Article 304 which requires that goods imported should not be subjected by any State to tax at a rate higher than what is locally manufactured or produced subject to requirement of public interest would clearly incorporate the concept of non-discrimination in taxation within the federation. Courts have held that there can be no differing rates as between the goods manufactured in the same State and those imported into the State. Where there is no local manufacture or production, there could be any rate of tax and Article 304 cannot be treated as violated as was decided in *Kalyani Stores v. State of Orissa* [AIR 1966 SC 1686] in the context of increase in rate on imported foreign liquor when there was no manufacture of such goods in the State.

Since the law recognized reasonable restrictions, the issue as to what is reasonable assumes importance. Such restrictions should relate to protection of public health, safety, morals and property. Mere pretence of preventing injury to welfare of citizens would not be acceptable as was held in *Tika Ramji v. State of UP* (1956) SCR 393. The argument that the enhancement of the existing rate was purely fiscal and reasonable in its object was found unacceptable in *Kalyani Stores v. State of Orissa* [AIR 1966 SC 1686]. Courts did find that it is not always easy to come to a conclusion one way or the other since contending arguments may lead to different interpretation. All that one can do is to consider the totality of the circumstances. Prohibition so as to keep out intoxicating liquors or clamping enhanced rate of tax on tobacco as a luxury involving health hazard may be treated as reasonable.

The tests laid down are that direct and minimum flow of movement of persons, animals or goods should not be affected and that the burden imposed should be merely regulatory or compensatory but it should not be excessive or confiscatory. Merely because what is imposed is a higher rate or a flat rate or validates earlier collection by retrospective law, it cannot be treated as constituting discrimination, but the extra burden imposed should clearly be not excessive.

The concept of non-discrimination between the States in trade and commerce was one of the basic objectives as stated by Das J. in what is described as Automobiles case [*Automobile Transport Ltd. v. State of Rajasthan* (AIR 1962 SC 1406)] in following words:

“It has been often stated that freedom of inter-State trade and commerce in a federation

has been a baffling problem to constitutional experts in Australia, in America and in other federal Constitutions. In evolving an integrated policy on this subject, our Constitution makers seem to have kept in mind three main considerations... first, in the larger interests of India there must be free flow of trade, commerce and intercourse, both inter-State and intra-State, second, the regional interests must not be ignored altogether, and third, there must be a power of intervention by the Union in any case of crisis to deal with particular problems that may arise in any part of India... all these three considerations have played their part in the . . . Articles in Part XIII”.

H. M. Seervai on the Constitution of India quotes the above passage with approval as laying down the essence of non-discrimination which does not rule out regional interest altogether. It has to be implemented by reconciling “political pluralism” with economic unity.

The guidelines available in these and other precedents should help to resolve the issue of non-discrimination even in respect of non-discrimination clause under Double Tax Avoidance Agreements. The controversy which has been sought to be tackled in respect of Indo-French Agreement in the ruling of Authority for Advance Ruling in Application No. 16 of 1998 (1999) 236 ITR 103 (AAR) is probably the beginning of more interpretative hassles with greater globalisation on the cards. The concept of excessive burden on the non-residents and the need for regional protection have to be reconciled, while in a Federal Constitution, non-discrimination between States should be the guiding principle. In the case of double tax avoidance agreement, non-discrimination should be with reference to the test of residence and not citizenship, though domicile and citizenship may not be entirely irrelevant, because double tax avoidance agreement recognizes these as tests for determining residence.

24.3.4 Other views on non-discrimination

In *Standard Chartered Bank v. IAC* (1991) 39 ITD 57 (a decision referred in Klaus Vogel, Philip Baker and some tax journals), the Tribunal had occasion to consider the clause relating to non-discrimination in the double tax avoidance agreement between India and UK in the context of the claim for bad debt. The assessee a non-resident bank claimed the benefit of deduction for a provision against, risks allowed under section 36(1) (viiia) for bad and doubtful debts for purposes of double tax relief. The authorities felt that the non-resident being a corporate entity could not be treated as a national, so that double tax avoidance agreement which makes reference to “national”, could have no application. On behalf of the assessee, the decision of the Supreme Court in *State Trading Corporation of Indian Ltd. v. CIT* [AIR 1963 SC 1811] was relied upon for the proposition that a company incorporated in UK could be treated as a national of UK. The decision of the Supreme Court had pointed out that all citizens will be nationals but all nationals may or may not be citizens. Any special exemption or favour to State Undertakings or charitable institutions need not be taken as an instance of discrimination as had been pointed out in Official Commentary on UN Model. The Commentary further would expect that the implementation of this clause would mean that a permanent establishment is entitled to all the business deductions, depreciation and other provisions, adjustment of brought-forward or backward losses to be allowed to the non-resident as for residents.

As regards rate of tax, the adoption of flat rate as against progressive rate need not constitute discrimination in UN Commentary. The split rate applicable to Corporations with reference to direct tax on the corporations and the tax on dividends on imputation system may have differing effects on the residents and non-residents. So is the position as to the treatment for credit to the foreign tax in the respective States having different fall-outs. In all these cases, the UN Commentary would suggest that such issues are settled by bilateral negotiations. A perfect parity is not possible because of the differing system of taxations, for example, in US non-resident citizens are taxed on their world-wide income, while India would consider citizenship irrelevant and would not tax even citizens who are non-residents on their foreign income.

There are several problems as to whether there is an alternative scheme of assessment as by way of Minimum Alternate Tax in India or tax on zero-tax companies as in US. Whether non-discrimination clause can apply, if presumptive tax is treated as falling beyond the scope of Double Tax Avoidance Agreements as now worded is a matter to be decided.

In *Ericsson Telephone Corporation of India AB v. CIT* (1997) 224 ITR 203 (AAR), the issue related to the manner of computation of income from installation, operation and training in respect of cellular communication. The issue under double income-tax relief was whether such income should be treated as business income or technical fees. This inference made a difference both under domestic law and double income-tax relief. A flat rate had been provided for technical fees at 30% while business income was assessable at 55%. The Authority for Advance Ruling found that the word 'national' would include a company but did not consider it appropriate to issue any direction as to the manner of computation of income at the stage of Advance Ruling, but was content to state that the rate of tax deduction should be at 30% though non-discrimination clause was relied upon in this case by the applicant. But the AAR reserved judgement on this issue by stating that whether the tax liability sought to be imposed on the recipient is in any way discriminatory can be resolved only after the assessment is made and the tax payable is determined.

Revenue had always taken the view that discrimination cannot be permitted only on the basis of nationality, but differential treatment between residents and non-residents is not covered by the non-discrimination clause in Double Tax Avoidance Agreement. The Authority for Advance Ruling in *Universities Superannuation Scheme Ltd. In re* [2005] 275 ITR 434 (AAR) accepted this argument against the taxpayer in the context of claim for indexation on sale of securities for purposes of tax on capital gains not available to non-residents under section 48, 112, 115I and 115AD.

The Tribunal in *Standard Chartered Bank v. IAC* [1991] 39 ITD 57 (Bom) had held that, where a foreign bank claimed the same deductions as for non-performing assets available to banks in India, disallowance of the claim would amount to discrimination and directed allowance by treating foreign bank as foreign national. This decision was noticed in foreign journals and the publication of Double Tax Avoidance Agreement by Klaus Vogel and Philip Baker.

Differential rate of tax has been another bone of controversy, as to whether it would constitute discrimination. An Explanation was inserted in section 90(3) to the effect that a higher rate of

tax on a foreign company as against a domestic company cannot be regarded as less favourable to the foreign company. But then, the concept of treaty override would mean that if non-discrimination clause is understood as not permitting differential rates, the amendment in the domestic law may not be an answer to the controversy. The more salutary course is to have an explanation to that effect in the Agreement itself. A provision in the Agreement is a notice to the non-resident, while a provision in domestic law is not.

In *Mitsubishi Corporation India (P) Ltd*²⁷⁸, the Delhi ITAT held that the restrictive clause in Article 24 of the India – Japan DTAA, which restricts applicability of the non-discrimination clause to cases covered by Article 9 (dealing with arms' length adjustment for AEs), is limited to its content alone and does not completely override the operation of non-discrimination clause. Since disallowance for non-deduction of tax at source is an independent component of the computation of total income, distinct from any transfer pricing adjustment, the taxpayer is entitled to invoke Article 24(3). The ITAT held that Article 24 read with Article 9 prohibits deletion of enhancement of income due to transfer pricing adjustment but permits deletion of enhancement of income due to non-deduction of tax at source.

In *Banca Sella S.P.A*²⁷⁹, the AAR held that the transfer of a branch office in a scheme of amalgamation between two foreign companies would not be chargeable to tax as capital gains, in the absence of any consideration (in which case the computation mechanism fails). The AAR further upheld the applicability of non-discrimination clause (Article 25) of India-Italy tax treaty, pursuant to which a non-resident transferor can invoke exemption from capital gains under section 47(vi) of the Act in a scheme of amalgamation.

24.3.5 Procedural law — Application

Non-discrimination clause may apply in respect of procedural matters as well. In computation of income of a permanent establishment, trading expenses, depreciation, right to carry forward losses and the rate of tax permitted under the domestic law, including deduction of proportionate overhead head office expenses should be available to the non-resident.

24.4 Instruction No. 1982 dated 11.4.2000

“Non-Discrimination Article under the Double Taxation Avoidance Agreements (DTAA)

The Board has had the occasion to examine this question of the rate of tax applicable to foreign companies doing business through a permanent establishment in India. The article on “Non-Discrimination” in the Double Taxation Avoidance Agreements between India and various countries normally contains the following sentence:—

“The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.”

²⁷⁸(2015) 171 TTJ 417 (Del ITAT)

²⁷⁹(2016) 387 ITR 358 (AAR)

Article 3 of DTAA's *inter alia* defines the term "Enterprise of a Contracting State" and "enterprise of the other Contracting State", respectively as an enterprise carried by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State.

2. The tax rates provided in the Finance Act are for "Domestic company" and "company other than a domestic company" i.e. for a foreign company. By definition (under section 2(22A) of Income-tax Act, 1961), a domestic company means an Indian company or any other company, which in respect of its income liable to tax in India makes prescribed arrangements for declaration and payment of dividends within India. A foreign company by definition (under section 2(23A) of Income-tax Act, 1961), is the one which is not a domestic company i.e. which has not made prescribed arrangements for declaration and payment of dividends in India. As against this, under section 6(3) of the Income-tax Act, 1961, a company is said to be resident in India if either it is an Indian company or if control and management of its affairs is situated wholly in India²⁸⁰. Thus, a non-resident company if it distributes dividends in India will be treated as a domestic company and will then be subjected to the same rate of tax as a resident company declaring and distributing dividends in India. *Thus there is no discrimination/differentiation in the corporate tax rates in India on the basis of "residence" The different rates of tax provided for "foreign company" vis-a-vis "domestic company" by the Finance Acts in India consequently do not discriminate against a Permanent Establishment (PE) of the non-resident company within the meaning of Non-Discrimination Article of the DTAA.*

3. Some of the DTAA's (for e.g., the one with UK) contain an additional sentence in the clause pertaining to Permanent Establishments (PE) in the Non-Discrimination Article specifically permitting taxation of PEs at a rate higher than domestic companies. This cannot be taken to mean that the same rule of construction will not apply to the DTAA's where such a sentence is absent. In fact, what was implicit in the DTAA's where such a sentence is not present has been made explicit in these DTAA's (like the one with UK)."

24.5 Recent ruling

Bhagwandas Nagla (2018) TS-32-ITAT-2018(HYD) (Hyd ITAT)

The Hyderabad ITAT upheld the assessee's liability to deduct tax at source under section 195 on payment of sale consideration for immovable property to non-resident vendors based in the USA. It rejected the assessee's stand that by virtue of non-discrimination clause under Article 26 of the India-US DTAA, TDS under section 195 cannot be made applicable to the transaction as there was no TDS applicable on payment of sale consideration to resident vendors during the relevant year. The Tribunal distinguished the assessee's reliance on Delhi ITAT ruling in Santur Developers Pvt. Ltd. (wherein Article 26 relief was granted) by clarifying that the case

²⁸⁰W.e.f. 1 April 2017, a company is said to be a resident in India in any previous year, if it is an Indian company or its place of effective management, in that year, is in India.

before it deals with the liability of the assessee to deduct TDS and not with the liability of the non-residents. It thus held that there was no discrimination against the recipient non-residents in the case before it.

Source:

1. United Nations Model Double Taxation Convention between developed & developing countries – Article 24
2. OECD Model Tax Convention on Income and on Capital (Condensed version) Article – 24
3. Treaties on Double Taxation Avoidance Agreements by S. Rajaratnam – Article 24 (2015)
4. Indian Double Taxation Agreements & Tax Laws by D.P. Mittal – Article 24(2014)

25. Article 25 – Mutual Agreement Procedure

25.1 General

- Despite a tax treaty, double taxation still occurs. It may happen because of the contracting states interpreting the treaty provisions differently. Article 25 (mutual agreement article) provides a special procedure to attempt reconciliation of the conflict at the level of the competent authorities of the states and consequently preventing double taxation. This is known as the mutual agreement procedure (MAP). The MAP can be used when double taxation has happened. The mutual agreement procedure is “a process of discussion between the competent authorities in which they seek to explore the possibilities of a solution to the relevant problem that can be accepted by all concerned”.
- The mutual agreement article of a tax treaty is designed to provide a mechanism for resolution of disputes concerning taxation where a disagreement exists between two contracting states. It institutes a mutual agreement procedure for resolving difficulties arising out of the application and interpretation of the treaty. The fact that a Tax treaty has been concluded does not necessarily preclude the eventuality of double taxation occurring on account of its provision being interpreted differently. The competent authorities of the Contracting States are under obligation to attempt resolution through the device of mutual agreement.
- To achieve the two basic objectives, viz., (a) avoidance of double taxation and thereby elimination of tax barriers to international trade and investment and (b) prevention of international tax evasion, the double taxation agreements seek to –
 - Mediate between competing jurisdictional bases for income taxation, between the source and residence;
 - to develop common framework for certain basic concepts necessary to the application of the agreements, such as determination of residence and entitlement of benefits; and
 - to establish mechanism for resolving inter-state disputes as well as elimination of

potential double taxation.

- The mutual agreement procedure is designed not only to furnish a means of settling questions relating to the interpretation and application of the Convention, but also to provide (a) a forum in which residents of the State involved can seek redress for actions not in accordance with the Convention and (b) a mechanism for eliminating double taxation in cases not provided for in the Convention. The mutual agreement procedure applies in connection with all Articles of the Convention and, in particular, to Article 7 on business profits, Article 9 on associated enterprises, Article 10 on dividends, Article 11 on interest, Article 12 on royalties and Article 23 on methods for the elimination of double taxation. Even if a bilateral convention does not contain paragraph 2 of Article 9, the inclusion of paragraph 1 of Article 9 is sufficient to indicate that the intention of the Contracting States was to have economic double taxation covered by the convention. As a result, most countries consider that, in the absence of rules similar to those of paragraph 2 of Article 9, economic double taxation resulting from adjustments made to profits by reason of transfer pricing falls within the scope of the mutual agreement procedure set up under Article 25.

In 2015 the OECD issued “Making Dispute Resolution Mechanism More Effective, Action 14 – 2015 Final Report”. Underlining the relevance of this Action it states as follows:

“The measures developed under Action 14 of the BEPS Action Plan aim to strengthen the effectiveness and efficiency of the MAP process. They aim to minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through the mutual agreement procedure. These measures are underpinned by a strong political commitment to the effective and timely resolution of disputes through the mutual agreement procedure and to further progress to rapidly resolve disputes.”²⁸¹

The Report identifies the minimum standards as follows”

“Through the adoption of this Report, countries have agreed to important changes in their approach to dispute resolution, in particular by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the Committee on Fiscal Affairs to the G20. The minimum standard will:

- *Ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner;*
- *Ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and*

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- *Ensure that taxpayers can access the MAP when eligible.*

The minimum standard is complemented by a set of best practices. The monitoring of the implementation of the minimum standard will be carried out pursuant to detailed terms of reference and an assessment methodology to be developed in the context of the OECD/G20 BEPS Project in 2016.”

In accordance with the stated intention of monitoring the implementation “Peer Reviews” are carried out. Such review was carried out in respect of India. The report presents mixed picture. However, on the broader level India has done better than many countries.

25.2 UN Model convention - Article 25

- Two alternative versions are given for Article 25 of the United Nations Model Convention. Alternative A reproduces Article 25 of the OECD Model Convention with the addition of a second sentence in paragraph 4 but excludes arbitration as is provided for in paragraph 5 of the OECD Model Convention. Alternative B reproduces Article 25 of the OECD Model Convention with the addition of a second sentence in paragraph 4 and includes mandatory arbitration as is provided for in paragraph 5 of the OECD Model Convention but with four differences. First paragraph 5 provides that arbitration may be initiated if the competent authorities are unable to reach an agreement on a case within three years from the presentation of that case rather than within two years as provided in the OECD Model Convention. Second, while the OECD Model Convention provides that arbitration must be requested by the person who initiated the case, paragraph 5 provides that arbitration must be requested by the competent authority of one of the Contracting states (this means that a case shall not be submitted to arbitration if the competent authorities of both Contracting States consider that such a case is not suitable for arbitration and neither of them makes a request). Third, paragraph 5, unlike the corresponding provision of the OECD Model Convention, allows the competent authority to depart from the arbitration decision if they agree to do so within six months after the decision has been communicated to them. Finally, as alternative A does not provide for arbitration, there is no need for a footnote similar to the one included in the OECD Model Convention mentioning that, for various reasons, some countries may wish not to include the arbitration provision in a tax treaty.
- The decision whether to agree in bilateral convention on a mutual agreement procedure without mandatory arbitration as in alternative A or with mandatory arbitration as in alternative B depends on policy and administrative considerations of each Contracting State and its actual experiences with mutual agreement procedures. Countries should in advance analyse the advantages and disadvantages of mandatory or voluntary arbitration and evaluate whether or not – arbitration is appropriate for them.
- The mutual agreement procedure is designed not only to furnish a means of settling questions relating to the interpretation and application of the Convention, but also to

provide (a) a forum in which residents of the States involved can seek redress for actions not in accordance with the Convention and (b) a mechanism for eliminating double taxation in cases not provided for in the Convention.

Mutual Agreement Procedure

Article 25 (Alternative A)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the Domestic Law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.
3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.

Article 25 (Alternative B)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

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2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.
3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.
5. Where,
 - (a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
 - (b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within three years from the presentation of the case to the competent authority of the other Contracting State, any unresolved issues arising from the case shall be submitted to arbitration if either competent authority so requests. The person who has presented the case shall be notified of the request. These unresolved issues shall not, however, be submitted to arbitration if a decision. On these issues has already been rendered by a court or administrative tribunal of either State. The arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraphs”.

a. Paragraph 1 and 2 of Article 25 (alternatives A and B) provide that:

1. The text of paragraph 1 & 2 of Article 25 of OECD is followed by UN Model Convention with a difference that in bilateral negotiations, States may wish to agree on a different time limit for the presentation of the case to the competent authority of a Contracting State.

2. The rules laid down in paragraphs 1 and 2 provide for the elimination in a particular case of taxation which does not accord with the Convention. As is known, in such cases it is normally open to taxpayers to litigate in the tax court, either immediately or upon the dismissal of their objections by the taxation authorities. When taxation not in accordance with the Convention arises from an incorrect application of the Convention in both States, taxpayers are then obliged to litigate in each State, with all the disadvantages and uncertainties that such a situation entails. So paragraph 1 makes available to taxpayers affected, without depriving them of the ordinary legal remedies available, a procedure which is called the mutual agreement procedure because it is aimed, in its second stage, at resolving the dispute on an agreed basis, i.e. by agreement between competent authorities, the first stage being conducted exclusively in the State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) from the presentation of the objection up to the decision taken regarding it by the competent authority on the matter.
3. In any case, the mutual agreement procedure is clearly a special procedure outside the domestic law.
4. In practice, the procedure applies to cases—by far the most numerous—where the measure in question leads to double taxation which it is the specific purpose of the Convention to avoid. Among the most common cases, mention must be made of the following:
 - questions relating to the attribution of profits to a permanent establishment under paragraph 2 of Article 7;
 - the taxation in the State of the payer—in case of a special relationship between the payer and the beneficial owner—of the excess part of interest and royalties, under the provisions of Article 9, paragraph 6 of Article 11 or paragraph [6 of Article 12 of the United Nations Model Convention];
 - cases of application of legislation to deal with thin capitalisation when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to Article 9 or paragraph 6 of Article 11;
 - cases where lack of information as to the taxpayer's actual situation has led to misapplication of the Conventions especially in regard to the determination of residence (paragraph 2 of Article 4), the existence of a permanent establishment (Article 5), or the temporary nature of the services performed by an employee (paragraph 2 of Article 15).
5. Article 25 also provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation, and especially those resulting from the inclusion of profits of associated enterprises under

paragraph 1 of Article 9; the corresponding adjustments to be made in pursuance of paragraph 2 of the same Article thus fall within the scope of the mutual agreement procedure, both as concerns assessing whether they are well-founded and for determining their amount.

6. The mutual agreement procedure is also applicable in the absence of any double taxation contrary to the Convention, once the taxation in dispute is in direct contravention of a rule in the Convention. Such is the case when one State taxes a particular class of income in respect of which the Convention gives an exclusive right to tax to the other State even though the latter is unable to exercise it owing to a gap in its domestic laws. Another category of cases concerns persons who, being nationals of one Contracting State but residents of the other State, are subjected in that other State to taxation treatment which is discriminatory under the provision of paragraph 1 of Article 24.
7. Since the first steps in a mutual agreement procedure may be set in motion at a very early stage based upon the mere probability of taxation not in accordance with the Convention, the initiation of the procedure in this manner would not be considered the presentation of the case to the competent authority for the purposes of determining the start of the [three-year] period referred to in paragraph 5 of (alternative B of this Article).
8. The Convention does not lay down any special rule as to the form of the objections. The competent authorities may prescribe special procedures which they feel to be appropriate. If no special procedure has been specified, the objections may be presented in the same way as objections regarding taxes are presented to the tax authorities of the State concerned.
9. The requirement laid on the taxpayer to present his case to the competent authority of the State of which he is a resident (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) is of general application, regardless of whether the taxation objected to has been charged in that or the other State and regardless of whether it has given rise to double taxation or not. If the taxpayer should have transferred his residence to the other Contracting State subsequently to the measure or taxation objected to, he must nevertheless still present his objection to the competent authority of the State of which he was a resident during the year in respect of which such taxation has been or is going to be charged.
10. However, in the case already alluded to where a person who is national of one State but a resident of the other complains of having been subjected in that other State to an action or taxation which is discriminatory under paragraph 1 of Article 24, it appears more appropriate for obvious reasons to allow him, by way of exception to the general rule set forth above, to present his objection to the competent authority of the Contracting State of which he is a national. Finally, it is to the same competent authority that an objection has to be presented by a person who, while not being a resident of a Contracting State, is a national of a Contracting State, and whose case comes under paragraph 1 of Article

24.

11. The time limit of three years set by the second sentence of paragraph 1 for presenting objections is intended to protect administrations against late objections. This time limit must be regarded as a minimum, so that Contracting States are left free to agree in their bilateral conventions upon a longer period in the interests of taxpayers, e.g. on the analogy in particular of the time limits laid down by their respective domestic regulations in regard to tax conventions. Contracting States may omit the second sentence of paragraph 1 if they concur that their respective domestic regulations apply automatically to such objections and are more favourable in their effects to the taxpayers affected, either because they allow a longer time for presenting objections or because they do not set any time limits for such purpose.
12. Some States may deny the taxpayer ability to initiate the agreement procedure under paragraph 1 of Article 25 in cases where the transactions to which the request relates are regarded as abusive. This issue is closely related to the issue of “improper use of the Convention” discussed [in paragraph 8 and the following paragraphs of the Commentary on Article 1 of the United Nations Model Convention]. In the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure, however. The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement. However, where serious violations of domestic laws resulting in significant penalties are involved, some States may wish to deny access to the mutual agreement procedure. The circumstances in which a State would deny access to the mutual agreement procedure should be made clear in the Convention.
13. As regards the procedure itself it is necessary to consider briefly the two distinct stages into which it is divided, in the first stage, which opens with the presentation of the taxpayer’s objections, the procedure takes place exclusively at the level of dealings between him and the competent authorities of his State of residence. The provisions of paragraph 1 give the taxpayer concerned the right to apply to the competent authority of the State of which he is a resident, whether or not he has exhausted all the remedies available to him under the domestic laws of each of the two states. On the other hand, the competent authority is under an obligation to consider whether the objection is justified. If it appears to be justified, take action on it in one of the two forms provided for in paragraph 2.
14. If a claim has been finally adjudicated by a court in the State of residence, a taxpayer may wish even so to present or pursue a claim under the mutual agreement procedure. In some States, competent authority may be able to arrive at a satisfactory solution which departs from the court decision. In other States, the competent authority is bound by the court decision. It may nevertheless present the case to the competent authority of the other Contracting State and ask the latter to take measures for avoiding double taxation.
15. In its second stage—which opens with the approach to the competent authority of the

other State by the competent authority to which the taxpayer has applied—the procedure is henceforward at the level of dealings between States, as if, so to speak, the State to which the complaint was presented had given it its backing. But whilst this procedure is indisputably a procedure between States, it may, on the other hand, be asked:

- Whether, as the title of the Article and the terms employed in the first sentence of paragraph 2 suggest, it is no more than a simple procedure of mutual agreement, or constitutes the implementation of a *pactum de contrahendo* laying on the parties a mere duty to negotiate but in no way laying on them a duty to reach agreement;
- or whether on the contrary, it is to be regarded (based [in the case of alternative B of the Article] on the existence of the arbitration process provided for in paragraph 5 [of that alternative] to address unresolved issues or on the assumption that the procedure takes place within the framework of a joint commission) as a procedure of a jurisdictional nature laying on the parties a duty to resolve the dispute.

16. In seeking a mutual agreement, the competent authorities must first, of course, determine their position in the light of the rules of their respective taxation laws and the provisions of the Convention, which are as binding on them as much as they are on the taxpayer. Should the strict application of such rules or provisions preclude any agreement, it may reasonably be held that the competent authorities, as in the case of international arbitration, can, subsidiarily, have regard to considerations of equity in order to give the taxpayer satisfaction.
17. The Committee on Fiscal Affairs made a number of recommendations on the problems raised by corresponding adjustments of profits following transfer pricing adjustments (implementation of paragraphs 1 and 2 of Article 9) and of the difficulties of applying the mutual agreement procedure to such situations:
 - a) Tax authorities should notify taxpayers as soon as possible of their intention to make a transfer pricing adjustment (and, where the date of any such notification may be important, to ensure that a clear formal notification is given as soon as possible), since it is particularly useful to ensure as early and as full contact as possible on all relevant matters between tax authorities and taxpayers within the same jurisdiction and, across national frontiers, between the associated enterprises and tax authorities concerned.
 - b) Competent authorities should communicate with each other in these matters in as flexible a manner as possible, whether in writing, by telephone, or by face-to-face or round-the-table discussion, whichever is most suitable, and should seek to develop the most effective ways of solving relevant problems. Use of the provisions of Article 26 on the exchange of information should be encouraged in order to assist the competent authorities in having well-developed factual information on which a decision can be made.
 - c) In the course of mutual agreement proceedings on transfer pricing matters, the taxpayers concerned should be given every reasonable opportunity to present the

relevant facts and arguments to the competent authorities both in writing and orally.

18. As regards the mutual agreement procedure in general, the Committee recommended that:
 - (a) The formalities involved in instituting and operating the mutual agreement procedure should be kept to a minimum and any unnecessary formalities eliminated.
 - (b) Mutual agreement cases should each be settled on their individual merits and not by reference to any balance of the results in other cases.
 - (c) Competent authorities should, where appropriate, formulate and publicise domestic rules, guidelines and procedures concerning use of the mutual agreement procedure.

b. Paragraph 3 of Article 25 (alternatives A and B) provide that:

1. This paragraph reproduces Article 25, paragraph 3, of the OECD Model Convention. The Committee considers that the following part of the OECD Commentary is therefore applicable to this paragraph.
2. The first sentence of this paragraph invites and authorizes the competent authorities to resolve, if possible, difficulties of interpretation or application by means of mutual agreement. These are essentially difficulties of a general nature which concern, or which may concern, a category of taxpayers, even if they have arisen in connection with an individual case normally coming under the procedure defined in paragraphs 1 and 2.
3. This provision makes it possible to resolve difficulties arising from the application of the Convention. Such difficulties are not only those of a practical nature, which might arise in connection with the setting up and operation of procedures for the relief from tax deducted from dividends, interest and royalties in the Contracting State in which they arise, but also those which could impair or impede the normal operation of the clauses of the Convention as they were conceived by the negotiators, the solution of which does not depend on a prior agreement as to the interpretation of the Convention.
4. Under this provision the competent authorities can, in particular:
 - Where a term has been incompletely or ambiguously defined in the Convention, complete or clarify its definition in order to obviate any difficulty;
 - Where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes;
 - Determine whether, and if so under what conditions, interest may be treated as dividends under thin capitalisation rules in the country of the borrower and give rise to relief for double taxation in the country of residence of the lender in the same way as for dividends (for example relief under a parent/subsidiary regime when provision for such relief is made in the relevant bilateral convention).

5. Paragraph 3 confers on the “competent authorities of the Contracting States”, i.e. generally the Ministers of Finance or their authorised representatives normally responsible for the administration of the Convention, authority to resolve by mutual agreement any difficulties arising as to the interpretation of the Convention. However, it is important not to lose sight of the fact that, depending on the domestic law of Contracting States, other authorities (Ministry of Foreign Affairs, courts) have the right to interpret international treaties and agreements as well as the “competent authority” designated in the Convention and that this is sometimes the exclusive right of such other authorities.
6. Mutual agreements resolving general difficulties of interpretation or application are binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.
7. The second sentence of paragraph 3 enables the competent authorities to deal also with such cases of double taxation as do not come within the scope of the provisions of the Convention. Of special interest in this connection is the case of a resident of a third State having permanent establishments in both Contracting States. It is not merely desirable, but in most cases also will particularly reflect the role of Article 25 and the mutual agreement procedure in providing that the competent authorities may consult together as a way of ensuring the Convention as a whole operates effectively, that the mutual agreement procedure should result in the effective elimination of the double taxation which can occur in such a situation. The opportunity for such matters to be dealt with under the mutual agreement procedure becomes increasingly important as Contracting States seek more coherent frameworks for issues of profit allocation involving branches, and this is an issue that could usefully be discussed at the time of negotiating conventions or protocols to them. There will be Contracting States whose domestic law prevents the Convention from being complemented on points which are not explicitly or at least implicitly dealt with in the Convention, however, and in these situations the Convention could be complemented by a protocol dealing with this issue. In most cases, however, the terms of the Convention itself, as interpreted in accordance with accepted tax treaty interpretation principles, will sufficiently support issues involving two branches of a third state entity being subject to the paragraph 3 procedures.

c. Paragraph 4 of Article 25 (alternatives A and B) provides that:

This paragraph consists of two sentences, the first of which reproduces the first sentence of Article 25, paragraph 4, of the OECD Model Convention, while the second sentence is not contained in that Model. In the first sentence, the words “including through a joint commission consisting of themselves or their representatives” were inserted in 1999 between the words “with each other directly” and “...for the purpose of reaching”, so as to bring the provision on a par with that of the corresponding provision in the OECD Model Convention. The second sentence allows the competent authorities to develop bilateral procedures for the implementation of the mutual agreement procedure.

1. This paragraph determines how the competent authorities may consult together for the

resolution by mutual agreement, either of an individual case coming under the procedure defined in paragraphs 1 and 2 or of general problems relating in particular to the interpretation or application of the Convention, and which are referred to in paragraph 3.

2. It provides first that the competent authorities may communicate with each other directly. It would therefore not be necessary to go through diplomatic channels.
3. The competent authorities may communicate with each other by letter, facsimile transmission, telephone, direct meetings, or any other convenient means. They may, if they wish, formally establish a joint commission for this purpose.
4. As to this joint commission, paragraph 4 leaves it to the competent authorities of the Contracting States to determine the number of members and the rules of procedure of this body.
5. However, whilst the Contracting States may avoid any formalism in this field, it is nevertheless their duty to give taxpayers whose cases are brought before the joint commission under paragraph 2 certain essential guarantees, namely:
 - the right to make representations in writing or orally, either in person or through a representative;
 - the right to be assisted by counsel.
6. However, disclosure to the taxpayer or his representatives of the papers in the case does not seem to be warranted, in view of the special nature of the procedure.
7. Without infringing upon the freedom of choice enjoyed in principle by the competent authorities in designating their representatives on the joint commission, it would be desirable for them to agree to entrust the chairmanship of each Delegation—which might include one or more representatives of the service responsible for the procedure—to a high official or judge chosen primarily on account of his special experience; it is reasonable to believe, in fact, that the participation of such persons would be likely to facilitate reaching an agreement.

d. Paragraph 5 of Article 25 (alternative B) provides that:

1. Paragraph 5, which is only found in alternative B of the Article, provides for mandatory arbitration under which the competent authorities are obliged to submit unresolved issues to arbitration if one of them so requests after they were unable to resolve these issues within a given period of time.
2. This paragraph reproduces paragraph 5 of Article 25 of the OECD Model Convention with four differences. First, the paragraph provides that arbitration may be initiated if the competent authorities are unable to reach an agreement on a case within three years from the presentation of that case rather than within two years as provided in the OECD Model Convention. Second, while the OECD Model Convention provides that arbitration must be requested by the person who initiated the case, paragraph 5 of alternative B provides that arbitration must be requested by the competent authority of one of the

Contracting States (this means that a case shall not be submitted to arbitration if the competent authorities of both Contracting States consider that such a case is not suitable for arbitration and neither of them make a request). Third, paragraph 5 of alternative B, unlike the corresponding provision of the OECD Model Convention, allows the competent authorities to depart from the arbitration decision if they agree on a different solution within six months after the decision has been communicated to them. Finally, the footnote that is found in the OECD Model Convention, according to which the inclusion of the provision may not be appropriate in certain circumstances, has been omitted as alternative A already deals with such situations.

3. For different reasons, some States consider that it is not appropriate to commit themselves to proceed to arbitration whenever the competent authority of the other Contracting State so requests. Those States may, however, wish to include in their treaties a voluntary arbitration provision under which both competent authorities must agree, on a case by case basis, to submit a case to arbitration before an arbitration procedure will begin.

If the competent authorities are unable to resolve by mutual agreement a case pursuant to paragraph 2, the case, may, if both competent authorities and the person who has presented the case pursuant to paragraph 2 agree, be submitted for arbitration, provided any person directly affected by the case agrees in writing to be bound by the decision of the arbitration board. If the competent authorities are unable to resolve by mutual agreement a difficulty or a doubt pursuant to paragraph 3, the difficulty or doubt may also, if both competent authorities agree, be submitted to arbitration. The decision of the arbitration board in a particular case shall be binding on the Contracting States with respect to that case. Where a general difficulty of interpretation or application is submitted to arbitration, the decision of the arbitration board shall be binding on the Contracting States as long as the competent authorities do not agree to modify or rescind the decision. The competent authorities shall by mutual agreement settle the procedures for such an arbitration board.

4. Voluntary arbitration allows greater control over the types of issues that will proceed to arbitration. Under voluntary arbitration countries preserve great flexibility as to the issues that will be subjected to arbitration and may restrict the potential number of cases that could proceed to arbitration and reduce the potential costs of arbitration.
5. Under voluntary arbitration, however, where the competent authority of one State refuses to depart from its own interpretations of the treaty with respect to specific issues that competent authority may also refuse to submit those issues to arbitration, with the result that mutual agreement procedure cases involving those issues may remain unresolved. The arbitration of issues on which the competent authorities disagree is essential to ensure that treaty disputes are effectively resolved in a consistent manner in both States. In this respect, arbitration that may be requested by either competent authority gives more certainty that unresolved issues will effectively be submitted for arbitration than voluntary arbitration which needs the agreement of both competent authorities.

6. Some States that decide to include alternative B in their bilateral treaties may prefer to amend paragraph 5 so that unresolved issues shall be submitted to arbitration at the request of the person who has presented the case. In order to do so, those States may replace the terms “any unresolved issues arising from the case shall be submitted to arbitration if either competent authority so requests. The person who has presented the case shall be notified of the request” by the terms “any unresolved issues arising from the case shall be submitted to arbitration if the person so requests”.
7. It is recognized, however, that in some States, National Law Policy or administrative considerations may not allow or justify the type of arbitration process provided for in the paragraph.

For example, there may be constitutional barriers preventing arbitrators from deciding tax issues. In addition, some countries may only be in a position to include this paragraph in treaties with particular States. For these reasons, the paragraph should only be included in the Convention where each State concludes that the process is capable of effective implementation.
8. In addition, some States may wish to include paragraph 5 but limit its application to a more restricted range of cases. For example, access to arbitration could be restricted to cases involving issues which are primarily factual in nature. It could also be possible to provide that arbitration would always be available for issues arising in certain classes of cases, for example, highly factual cases such as those related to transfer pricing or the question of the existence of a permanent establishment, whilst extending arbitration to other issues on case – by – case basis.
9. States which are members of the European Union must coordinate the scope of paragraph 5 with their obligations under the European Arbitration Convention.
10. Where two Contracting States that have not included the paragraph in their Convention wish to implement an arbitration process for general application or to deal with a specific case, it is still possible for them to do so by mutual agreement.
11. The arbitration process is only available in cases where the person considers that taxation not in accordance with the provisions of the Convention has actually resulted from the actions of one or both of the Contracting States; it is not available, however, in cases where it is argued that such taxation will eventually result from such actions even if the latter cases may be presented to the competent authorities under paragraph I of the Article [...]. For that purpose, taxation should be considered to have resulted from the actions of one or both of the Contracting States as soon as, for example, tax has been paid, assessed or otherwise determined or even in cases where the taxpayer is officially notified by the tax authorities that they intend to tax him on a certain element of income.
12. The arbitration decision is only binding with respect to the specific issues submitted to arbitration. Whilst nothing would prevent the competent authorities from solving other similar cases (including cases involving the same persons but different taxable periods)

on the basis of the decision, there is no obligation to do so and each State therefore has the right to adopt a different approach to deal with these other cases.

13. Paragraph 5 allows the competent authorities to agree on a solution that is different from the solution adopted in the arbitration decision provided they do so within six months after the arbitration decision has been communicated to them. The arbitration decision is consequently not binding if both competent authorities consider that the decision is not appropriate and are able to agree on a different solution within the stated period.
14. At any time after arbitration has been requested pursuant to paragraph 5 and before the arbitrators have communicated a decision to the competent authorities, the competent authorities may agree on a resolution of the unresolved issues that led to arbitration. If so, the case shall be considered as resolved under the mutual agreement procedure and no arbitration decision shall be provided.

25.3 Procedural Issues

The last sentence of paragraph 4 of Article 25 (alternatives A and B) allows the competent authorities to develop bilateral procedures for the implementation of the mutual agreement procedure.

The procedural arrangements for mutual agreements in general should be suitable to the number and types of issues expected to be dealt with by the competent authorities and to the administrative capability and resources of those authorities. The arrangements should not be rigidly structured but instead should embody the degree of flexibility required to facilitate consultation and agreement rather than hinder them by elaborate procedural requirements and mechanisms. But even relatively simple procedural arrangements must incorporate certain minimum rules that inform taxpayers of their essential rights and obligations under the mutual agreement procedure. Such minimum rules would appear to involve such questions as:

- At what stage in a tax matter a taxpayer can invoke action by the competent authority under the mutual agreement procedure;
 - Whether any particular form must be followed by a taxpayer in invoking action by the competent authority;
 - Whether any time limits are applicable to a taxpayer's invocation of action by the competent authority;
 - If a taxpayer invokes action by the competent authority, whether the taxpayer is bound by the decision of the competent authorities and whether the taxpayer must waive recourse to other administrative or judicial processes as a condition for the implementation of a proposed mutual agreement reached by the competent authorities;
 - In what manner, if at all, a taxpayer can participate in the competent authority proceedings and what requirements regarding the furnishing of information by a taxpayer are involved.
- (b) Necessary cooperation of the person who makes the request.

25.4 Sample Mutual Agreement on Arbitration

(Annex to the Commentary on Paragraph 5 of Article 25 (Alternative B))

1. The Committee considers that the paragraphs of the Annex to the Commentary on paragraph 5 of Article 25 of the OECD Model Convention that are reproduced below are relevant for the application of paragraph 5 of alternative B of the Article. The additional comments that appear between square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the two versions of the paragraph as well as the differences introduced in the sample mutual agreement itself, which are primarily:
 - The following sample mutual agreement provides that, unless the competent authorities agree in a particular case that the arbitration panel will issue an independent decision, the so-called “last best offer” or “final offer” approach (commonly referred to as “baseball arbitration”) will be followed. Such a simplified arbitration process is less costly. Choosing between the competent authorities’ positions on each of the questions to be resolved will be quicker than developing and issuing an independent opinion on each of these questions; in addition, such choice may require only one independent arbitrator even if the basic rule is to have three arbitrators.
 - The sample mutual agreement provides also that a case shall not be submitted to arbitration if it involves less than a certain amount of taxes (to be specified by the competent authorities). Such cases shall only be submitted to arbitration if both competent authorities agree that it is appropriate to do so (e.g. in order to resolve a question of principle). Clearly, however, taxpayers expect competent authorities to directly resolve cases that involve small amounts of taxes and no questions of principle.
 - In order to guarantee their neutrality, the sample agreement provides that the appointed arbitrators are asked to fill in a statement in which they declare that, as far as they know, there exist no circumstances that might give rise to justifiable doubts regarding their independence or impartiality and that they will disclose promptly in writing to both competent authorities any such circumstances arising during the course of the arbitration process.
 - The sample mutual agreement contains some rules in order to determine the remuneration of the arbitrators.
2. The OECD paragraphs included in the Annex to the Commentary on Article 25, paragraph 5 read as follows:

The following is a sample form of agreement that the competent authorities may use as a basis for a mutual agreement to implement the arbitration process provided for in paragraph 5 of [alternative B of the Article]. Paragraphs 2 to 43 below discuss the various

provisions of the agreement and, in some cases, put forward alternatives. Competent authorities are of course free to modify, add or delete any provisions of this sample agreement when concluding their bilateral agreement.

Mutual agreement on the implementation of paragraph 5 of Article 25

The competent authorities of [State A] and [State B] have entered into the following mutual agreement to establish the mode of application of the arbitration process provided for in paragraph 5 of Article 25 of the [title of the Convention], which entered into force on [date of entry into force]. The competent authorities may modify or supplement this agreement by an exchange of letters between them.

- ***Request for submission of case to arbitration***

A request that unresolved issues arising from a mutual agreement case be submitted to arbitration pursuant to paragraph 5 of Article 25 of the Convention (the “request for arbitration”) shall be made in writing and sent [by one competent authority to the other competent authority and to the person who has presented the case to the competent authority of a Contracting State pursuant to paragraph 1 of Article 25]. The request shall contain sufficient information to identify the case. The request shall also be accompanied by a written statement by each of the persons who either [has presented the case] or is directly affected by the case that no decision on the same issues has already been rendered by a court or administrative tribunal of the States [...].

[No request for arbitration shall be made by a competent authority where the amount of taxes involved in the relevant mutual agreement procedure case is less than [amount to be determined bilaterally], unless both competent authorities agree that it is appropriate to do so (e.g. in order to resolve a question of principle).]

- ***Time for submission of the case to arbitration***

A request for arbitration may only be made after [three] years from the date on which a case presented to the competent authority of one Contracting State under paragraph 1 of Article 25 has also been presented to the competent authority of the other State. For this purpose, a case shall be considered to have been presented to the competent authority of the other State only if the following information has been presented: [the necessary information and documents will be specified in the agreement].

- ***Terms of Reference***

Within three months after the request for arbitration has been received by [the other competent authority], the competent authorities shall agree on the questions to be resolved by the arbitration panel and communicate them in writing to the person who [has presented the case]. This will constitute the “Terms of Reference” for the case. Notwithstanding the following paragraphs of this agreement, the competent authorities may also, in the Terms of Reference, provide procedural rules that are additional to, or different from, those included in these paragraphs and deal with such other matters as

are deemed appropriate.

- ***Failure to communicate the Terms of Reference***

If [,] within the period referred to in paragraph 3 above, [the Terms of Reference have not been agreed by the competent authorities and communicated to the person who has presented the case,] each competent authority may within one month after the end of that period, communicate in writing to each other a list of issues to be resolved by the arbitration. All the lists so communicated during that period shall constitute the tentative Terms of Reference. Within one month after all the arbitrators have been appointed as provided in paragraph 5 below, the arbitrators shall communicate to the competent authorities and the person who [presented the case] a revised version of the tentative Terms of Reference based on the lists so communicated. Within one month after the revised version has been received by both of them, the competent authorities will have the possibility to agree on different Terms of Reference and to communicate them in writing to the arbitrators and the person who [presented the case]. If they do so within that period, these different Terms of Reference shall constitute the Terms of Reference for the case. If no different Terms of Reference have been agreed to between the competent authorities and communicated in writing within that period, the revised version of the tentative Terms of Reference prepared by the arbitrators shall constitute the Terms of Reference for the case.

- ***Selection of arbitrators***

Within three months after the Terms of Reference have been received by the person who [presented the case] or, where paragraph 4 applies, within four months after the request for arbitration has been received by [the other] competent authority, the competent authorities shall each appoint one arbitrator. Within two months of the latter appointment, the arbitrators so appointed will appoint a third arbitrator who will function as Chair. If any appointment is not made within the required time period, the arbitrator(s) not yet appointed shall be appointed by the [Chair of the UN Committee of Experts on International Cooperation in Tax Matters, or if the Chair is a national or resident of one of the two States involved in the case, by the longest serving member of that Committee who is not a national or resident of these States. Such appointment shall be made] within [one month] of receiving a request to that effect [from either competent authority] The same procedure shall apply with the necessary adaptations if for any reason it is necessary to replace an arbitrator after the arbitral process has begun. Unless the Terms of Reference provide otherwise, the remuneration of all arbitrators.. [Will be determined as follows under the streamlined arbitration process:

- The fees of the arbitrators will be set at the fixed amount of [amount to be determined bilaterally] per day, subject to modification by the competent authorities.
- For one case, each arbitrator will be compensated for no more than three days of

preparation, for two meeting days (including through video-conference) and for the travel days necessary to attend the meetings. If, however, the arbitrators consider that they require additional time to properly consider the case, the arbitrators may be compensated for additional time.

- In addition, arbitrators are entitled to be reimbursed for reasonable expenses subject to prior authorization by the competent authorities.]

- ***Streamlined arbitration process***

[Unless the competent authorities indicate otherwise in the Terms of Reference,] the following rules shall apply to a particular case

[a)] Within two months from the appointment of the [arbitrators or, where paragraph 4 applies,, within two months from the end of the period during which the competent authorities may agree on and communicate different Terms of Reference], each competent authority will present in writing to the [arbitrators] its own reply to the questions contained in the Terms of Reference.

[b)] Within [three] month[s] from having received the last of the replies from the competent authorities, the [arbitrators] will decide each question included in the Terms of Reference in accordance with one of the two replies received from the competent authorities as regards that question and will notify the competent authorities of the choice, together with short reasons explaining that choice. Such decision will be implemented.

- ***Eligibility and appointment of arbitrators***

Any person, including a government official of a Contracting State, may be appointed as an arbitrator, unless that person has been involved in prior stages of the case that results in the arbitration process. [Before his appointment, an arbitrator will provide a written statement in which he declares that, as far as he knows, there exist no circumstances that might give rise to justifiable doubts regarding his independence or impartiality and that he will disclose promptly in writing to both competent authorities any such circumstances arising during the course of the arbitration process.] An arbitrator will be considered to have been appointed when a letter confirming that appointment has been signed both by the person or persons who have the power to appoint that arbitrator and by the arbitrator himself.

- ***Communication of information and confidentiality***

For the sole purposes of the application of the provisions of Articles 25 and 26, and of the domestic laws of the Contracting States, concerning the communication and the confidentiality of the information related to the case that results in the arbitration process, each arbitrator shall be designated as authorised representative of the competent authority that has appointed that arbitrator or, if that arbitrator has not been appointed

exclusively by one competent authority, of the competent authority of the Contracting State to which the case giving rise to the arbitration was initially presented. For the purposes of this agreement, where a case giving rise to arbitration was initially presented simultaneously to both competent authorities, “the competent authority of the Contracting State to which the case giving rise to the arbitration was initially presented” means the competent authority referred to in paragraph 1 of Article 25.

- ***Failure to provide information in a timely manner***

Notwithstanding [paragraph 5], where both competent authorities agree that the failure to resolve an issue within the [three] year period provided in paragraph 5 of Article 25 is mainly attributable to the failure of a person directly affected by the case to provide relevant information in a timely manner, the competent authorities may postpone the nomination of the arbitrator for a period of time corresponding to the delay in providing that information.

- ***Procedural and evidentiary rules***

Subject to this agreement and the Terms of Reference, the arbitrators shall adopt those procedural and evidentiary rules that they deem necessary to answer the questions set out in the Terms of Reference. They will have access to all information necessary to decide the issues submitted to arbitration, including confidential information. Unless the competent authorities agree otherwise, any information that was not available to both competent authorities before the request for arbitration was [sent by one] of them shall not be taken into account for purposes of the decision.

- ***Independent opinion approach***

If the competent authorities so indicate in the Terms of Reference, the “independent opinion” approach will be followed instead of the streamlined arbitration process. Under this approach, the arbitrators will reach their own decision and the following rules shall apply to a particular case:

- a) Unless otherwise provided in the Terms of Reference, the decision of the arbitral panel will be presented in writing and shall indicate the sources of law relied upon and the reasoning which led to its result. With the permission of the person who presented the case and both competent authorities, the decision of the arbitral panel will be made public in redacted form without mentioning the names of the parties involved or any details that might disclose their identity and with the understanding that the decision has no formal precedential value.
- b) The arbitration decision must be communicated to the competent authorities and the person who presented the case within six months from the date on which the Chair notifies in writing the competent authorities and the person who presented the case that he has received all the information necessary to begin consideration of the case. Notwithstanding the first part of this paragraph, if at any time within

two months from the date on which the last arbitrator was appointed, the Chair, with the consent of one of the competent authorities, notifies in writing the other competent authority and the person who presented the case that he has not received all the information necessary to begin consideration of the case, then

- if the Chair receives the necessary information within two months after the date on which that notice was sent, the arbitration decision must be communicated to the competent authorities and the person who presented the case within six months from the date on which the information was received by the Chair, and
 - if the Chair has not received the necessary information within two months after the date on which that notice was sent, the arbitration decision must, unless the competent authorities agree otherwise, be reached without taking into account that information even if the Chair receives it later and the decision must be communicated to the competent authorities and the person who presented the case within eight months from the date on which the notice was sent.
- c) The person who presented the case may, either directly or through his representatives, present his position to the arbitrators in writing to the same extent that the person is entitled to do so during the mutual agreement procedure.

- ***Logistical arrangements***

Unless agreed otherwise by the competent authorities, the competent authority to which the case giving rise to the arbitration was initially presented will be responsible for the logistical arrangements for the meetings of the arbitral panel and will provide the administrative personnel necessary for the conduct of the arbitration process. The administrative personnel so provided will report only to the Chair of the arbitration panel concerning any matter related to that process.

- ***Costs***

Unless agreed otherwise by the competent authorities:

- a) Each competent authority and the person who [presented the case] will bear the costs related to his own participation in the arbitration proceedings (including travel costs and costs related to the preparation and presentation of his views);
- b) Each competent authority will bear the remuneration of the arbitrator appointed exclusively by that competent authority, or appointed by [another person] because of the failure of that competent authority to appoint that arbitrator, together with that arbitrator's travel, telecommunication and secretariat costs;
- c) The remuneration of the other arbitrators and their travel, telecommunication and secretariat costs will be borne equally by the two Contracting States;

- d) Costs related to the meetings of the arbitral panel and to the administrative personnel necessary for the conduct of the arbitration process will be borne by the competent authority to which the case giving rise to the arbitration was initially presented, or if presented in both States, will be shared equally; and
- e) all other costs (including costs of translation and of recording the proceedings) related to expenses that both competent authorities have agreed to incur, will be borne equally by the two Contracting States.

- ***Applicable Legal Principles***

The arbitrators shall decide the issues submitted to arbitration in accordance with the applicable provisions of the [Convention] and, subject to these provisions, of those of the domestic laws of the Contracting States. Issues of treaty interpretation will be decided by the arbitrators in the light of the principles of interpretation incorporated in Articles 31 to 33 of the Vienna Convention on the Law of Treaties. The arbitrators will also consider any other sources which the competent authorities may expressly identify in the Terms of Reference.

- ***Arbitration decision***

Where more than one arbitrator has been appointed, the arbitration decision will be determined by a simple majority of the arbitrators.

- ***Failure to communicate the decision within the required period***

In the event that the decision has not been communicated to the competent authorities within the period provided for in paragraphs 6 [b)] or [11b), the competent authorities may agree to extend that period for a period not exceeding six months or, if they fail to do so within one month from the end of the period provided for in paragraphs 6(b) or 11(b) they shall appoint a new arbitrator or arbitrators in accordance with paragraph 5.

- ***Final decision***

The arbitration decision shall be final, [unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or unless that decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or of any procedural rule included in the Terms of Reference or in this agreement that may reasonably have affected the decision. If a decision is found to be unenforceable for one of these reasons [or if both competent authorities agree on a different solution within six months after the decision has been communicated to them], the request for arbitration shall be considered not to have been made and the arbitration process shall be considered not to have taken place (except for the purposes of paragraphs 8 “Communication of information and confidentiality” and 13 “Costs”).

- ***Implementing the arbitration decision***

[Unless both competent authorities agree on a different solution as provided in paragraph 17 above], the competent authorities will implement the arbitration decision within six months from the communication of the decision to them by reaching a mutual agreement on the case that led to the arbitration.

- ***Where no arbitration decision will be provided***

Notwithstanding paragraphs 6, 11 and 16, where, at any time after a request for arbitration has been made and before the arbitrators have delivered a decision to the competent authorities and the person who [presented the case], the competent authorities notify in writing the arbitrators and that person that they have solved all the unresolved issues described in the Terms of Reference, the case shall be considered as solved under the mutual agreement procedure and no arbitration decision shall be provided.

This agreement applies to any request for arbitration made pursuant to paragraph 5 of Article 25 of the Convention after that provision has become effective.

[Date of signature of the agreement]

[Signature of the competent authority of each Contracting State]

25.5 General approach of the sample agreement

1. A number of approaches can be taken to structuring the arbitral process which is used to supplement the mutual agreement procedure. Under one approach, which might be referred to as the “independent opinion” approach, the arbitrators would be presented with the facts and arguments by the parties based on the applicable law, and would then reach their own independent decision which would be based on a written, reasoned analysis of the facts involved and applicable legal sources.
2. Alternatively, under the so-called “last best offer” or “final offer” approach, each competent authority would be required to give to the arbitral panel a proposed resolution of the issue involved and the arbitral panel would choose between the two proposals which were presented to it. There are obviously a number of variations between these two positions. For example, the arbitrators could reach an independent decision but would not be required to submit a written decision but simply their conclusions. To some extent, the appropriate method depends on the type of issue to be decided.

25.6 Practical issues

25.6.1 Access to MAP – Conditions

Paragraph 1 of the article prescribes the following three conditions for having access to the mutual agreement process:

- The taxpayer if he considers that the actions of the one or both the contracting states result or will result for him in taxation not in accordance with the provisions of the convention, he may,

- Present his case within three years from the notification of the said action,
- To the competent authority of the state of which he is resident or national (if his case comes under paragraph 1 of article 24), irrespective of the remedies provided under the domestic law.

25.6.2 Not a substitute for remedies under the domestic laws

Mutual agreement procedure is not a substitute for remedies available under the domestic laws - The article lays down procedure for resolving difficulties arising out of the acts of the taxing authorities which in the opinion of the taxpayer do not conform to the intent, express or implied of the double taxation agreement between the two Contracting States. Such a procedure is not a substitute to the remedies available under domestic laws for redressal of the grievance, but is in addition to them. The aim and purpose of the introduction of this article appears to be, to save a taxpayer from the lengthy and expensive procedure of litigation under the domestic laws and their uncertainties.

The commentary on the OECD/UN Model makes it clear that this procedure is in addition to and not in substitution of the remedies in the domestic courts or tribunals. This article could be invoked in addition to any legal form of appeal in the country concerned.

25.6.3 Actuality of taxation

Taxation could be said to have actually resulted from the action of the contracting state as soon as, for example, tax has been paid, assessed or otherwise determined or even cases where the taxpayer is officially notified by the tax authorities that they intend to tax him on a certain element of income.

25.6.4 Assistance denied if not justified - *Circumstances*

Upon receipt of a request for assistance the competent authority of the resident State, may arrive at a satisfactory solution, if it believes that the facts justify assistance. It may deny if the applicant:—

- is not its resident unless the tax treaty provides otherwise;
- is not entitled to the treaty benefits;
- does not cooperate with it by providing relevant information and record.

25.6.5 Taxpayer not to participate –

The competent authority may consult with the competent authority of the other State, though it is not necessary. The taxpayer is not to participate in the process. The participation is limited to co-operating with the competent authority by providing relevant information or records.

25.6.6 Presentation of case -

The case is presented to the competent authority—

- Where actions of the State result or will result in taxation not in accordance with the convention;

- By the taxpayer who is its resident (unless his case comes under paragraph 1 of Article 24);
- Within three years from the notification of the said action.

25.6.7 No form prescribed

No form or rule has been provided for doing so. The competent authorities may prescribe special procedures which they feel appropriate. If no procedure is specified, the objections may be presented in the same way as objections regarding taxes are presented to the tax authorities of the state concerned.

25.6.8 Resolution of a dispute – Two stages

A reading of paragraph 1 and 2 of Article 25 suggests two stages for the resolution of dispute. In the first stage, the procedure takes place exclusively at the level of dealings between the taxpayer and the competent authorities of the state of which he is resident.

25.6.9 Attempt but not obliged to arrive at a solution

The article is not a complete answer to the difficulties of a taxpayer. The competent authorities are required to make an attempt but not obliged to arrive at a solution. There is likelihood of the provisions of the tax treaty being interpreted or applied differently in the two Contracting States and the competent authorities not agreeing to a solution. Double taxation may persist which the treaty aims at avoiding. Arbitration appears to be the solution based on equity considerations.

25.6.10 Issues possible of solution by mutual agreement procedure

There are a number of issues in interpretation of double tax agreement as decided in appeals or decided by authority for advance Ruling, which are not to the satisfaction in the sense that the scope of Agreement is differently interpreted.

In Application No. P.16 of 1998, (1999) In re, 236 ITR 103 (AAR), it was held by the Authority for Advance Ruling that the DTA agreements cannot whittle down the rate of tax fixed by the Parliament. This decision which has since been set aside by the Supreme Court for lack of jurisdiction in *Societe General v. CIT* (2001) 251 ITR 657 (SC) is best decided more expeditiously and probably more satisfactorily by mutual agreement procedure between Government of India and France.

So is the view that where there is presumptive tax, double tax avoidance agreement will have no application, as held in *N. V. Jan De Nul v. CIT* (1999) 236 ITR 489 (AAR) is controversial.

Minimum Alternate Tax, it was held, would be applicable to non-resident companies in P. No. 14 of 1997 (1998) 234 ITR 335 (AAR) and *Niko Resources Ltd v. CIT* (1998) 234 ITR 828 (AAR). Apart from the fact that issue as decided is not free from doubt, it would generate some controversies as to how the DTA Agreement can be implemented especially in the light of possible adjustment of such tax against future liability under section 115-JAA for years for which they are available.

Where there is conflicting interpretation of a technical term as between domestic law and

international law as for technical services rendered abroad or where there is technical service without a permanent establishment, as noticed in P16 of 1995 (1998) 234 ITR 371 (AAR) it is best resolved by mutual consultation. In matters of TDS again, there are different perceptions as in matters of stock option abroad by parent company as in P. No. 15 of 1998 (1999) 235 ITR 565. Interpretation of 183 days rule or the necessity or otherwise of physical presence to constitute permanent establishment or the impact of satellite communications, internet trade etc. on domestic law and its fallout on DTA Agreements are some other matters which are fit subjects for mutual consultation.

In this case, the AAR pointed out to the following position of law:

“A perusal of these provisions would make it clear that these are special provisions which have to be read together, for computing and taxing income by way of royalties and fees for technical services in the case of foreign companies. Section 44D starts with an overriding expression “notwithstanding anything to the contrary contained in sections 28 to 44C . . . “. This means that section 44D has application in respect of royalties and technical fees in the course of a business and that its special provisions take precedence over sections 28 to 44C and override these provisions. That means section 44BB is also superseded in respect of computation of income by way of royalties or fees for technical services received from an Indian concern (“X” in this case). The proviso to section 44BB excluding the application of that section to cases covered by section 44D is consistent with and complementary to this. This double safeguard provided by the statute shows that section 44D includes within its purview also royalties and technical service fees arising in the course of business.”

Such problems as faced in this case are best resolved by mutual agreement procedure.

25.6.11 Mutual agreement binding

Mutual agreement resolving general difficulties of interpretation or application are binding on administrations. The agreement need not conform to the internal law provisions of either Contracting States.

The contracting states are obliged to implement the mutual agreement, notwithstanding any contrary domestic provision. Even when the domestic law is changed, the obligation still operates.

Paragraph 29 of the OECD Commentary on article 25 provides:

“There is less justification for relying on domestic law for not implementing an agreement reached as part of the mutual agreement procedure. The obligation of implementing such agreements is unequivocally stated in the last sentence of paragraph 2, and impediments to implementation that were already existing should generally be built into the terms of the agreement itself. As tax conventions are negotiated against a background of changing body of domestic law that is sometime difficult to predict, and as both parties are aware of this in negotiating the original Convention and in reaching mutual agreements, subsequent unexpected changes that alter the fundamental basis of a mutual agreement would generally be considered as requiring revision of the agreement to the extent necessary. Obviously where there is a

domestic law development of this type, something that should only rarely occur, good faith obligations require that it be notified as soon as possible, and there should be good faith effort to seek a revised or new mutual agreement, to the extent the domestic law development allows. In these cases, the taxpayer's request should be regarded as still operative, rather than a new application being required from that person."

25.6.12 Mutual agreement - Limitations

Paragraph 3 only authorizes the competent authorities to reach an agreement to resolve problems, in order to avoid double taxation. Problems of major policy significance are not to be the subject matter of such agreement. These are the subject of negotiations between the Contracting States themselves. For example, paragraph 3 of Article 25 would not authorize the competent authorities to agree to allow a foreign tax credit under the treaty for a tax imposed by the other country where that tax is not otherwise a covered tax and is not an identical or substantially similar tax imposed after the date of signature of the treaty.

25.6.13 Double taxation in cases not provided for in the Convention

The second part of paragraph 3 of Article 25 authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention and to resolve any difficulties or doubts arising as to the application of the Convention. They may deal with cases not specifically covered in a treaty. An example is provided by the Technical Explanation on the US Model Convention:

"An example of such a case might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third country resident, one in the United States and one in the other Contracting State. Since no resident of a Contracting State is involved in the case, the Convention does not apply, but the competent authorities nevertheless may use the authority of the convention to prevent double taxation."

25.6.14 Procedure

Paragraph 4 prescribes procedure how competent authorities would proceed. They may communicate with each other directly for the purpose of applying the provisions of the agreement, without going through diplomatic channels. In order to reach an agreement, oral exchange of opinion may be necessary or advisable. For that purpose a commission may be constituted, consisting of the representatives of the competent authorities. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in the article. In addition, a competent authority may devise appropriate unilateral procedure etc., to facilitate the above mentioned bilateral actions and the implementation of the mutual agreement procedure.

25.6.15 Procedure for giving effect to the agreement in India

Under the Indian law (section 295(2)(h) of the Indian Income-tax Act, 1961), the Central Board of Direct Taxes has been empowered, subject to the control of the Central Government, to make rules providing procedures for giving effect to the terms of any agreement for granting of relief in respect of double taxation or for the avoidance of double taxation. By virtue of those powers

the Central Board has formulated rule 44G and rule 44H of the Income-tax Rules, 1962 operative with effect from 6-2-2003, as corrected by Notification No. 39/2003 (No. 480/3/2002 (FTD), dated 26-2-2003). Rule 44G provides that where a resident assessee is aggrieved by any action of the tax authorities of any country outside India for the reason that, according to him, such action is not in accordance with the terms of agreement with such other country outside India, he may make an application to the competent authority of India, i.e., the officer authorised by the Central Government for the purposes of discharging the functions as such [Foreign Tax and Tax Research, Department of Revenue, Ministry of Finance, New Delhi], seeking to invoke the mutual agreement procedure, if any provided therein, in terms of Form No. 34F. That form requires some factual information and details to be provided, as name, residential and official address of the applicant, his status, name and designation of the tax authority in the foreign state, date of notice or order giving rise to the action, permanent account number, assessment year, previous year(s). He is required to give reasons how the order/action of the tax authority of the country outside India is contrary to the provisions of the agreement. He is required to enclose a copy of the notice or order giving rise to action and any other document in support of his claim. He is required to make the application under a verification declaring that to best of his knowledge and belief the information given in his application and the annexures and the statements accompanying is correct and complete and particulars shown therein are truly stated and relate to the previous year(s) relevant to the assessment year and that he has not concealed any fact or information which could be relevant for deciding his application.

He is also to declare his capacity and competence to make the application and verify it.

Rule 44H prescribes the procedure - Rule 44H provides for the action by the competent authority of India and for the procedure for giving effect to the decision under the agreement. On receipt of the application, the competent authority shall call for and examine the relevant records with a view to give his response to the competent authority of the country outside India and shall endeavour to arrive at a resolution. The resolution arrived at in consultation with the competent authority of the other country shall be communicated to the Chief Commissioner/Director General of Income-tax who shall give effect within ninety days, if the assessee gives his acceptance and withdraws his appeal if pending. The amount of tax, interest or penalty already determined shall then be adjusted to the extent they are not contrary to the resolution arrived at.

25.6.16 Collection of taxes suspended

Collection of taxes is suspended during mutual agreement procedure for dispute arising in respect of the Indian tax treaties with UK, USA and Denmark under the following instructions issued by the Central Board of Direct Taxes:

- Instruction No. 3 of 2004, dated 19-3-2004 (India-UK);
- Instruction No. 10/2007, dated 23-10-2007 (India-US);
- Instruction No. 7/2008, dated 24-6-2008 (India-Denmark).

25.6.17 Resolution through arbitration

Paragraph 5 provides for the resolution through the mechanism of arbitration of unresolved

issues which could not be resolved by the competent authorities, at the request of the person who represented the case to the competent authority. That mechanism is not available if a decision on these issues has already been rendered by the court or the administrative tribunal of either state. It is also not available in cases where the action of the state has not as yet actually resulted but, in the opinion of the taxpayer, would eventually result taxation contrary to the provisions of the convention. The decision in the arbitration is binding on both contracting states and to be implemented notwithstanding any time limits in the domestic laws of these states.

25.6.18 Access to MAP not denied.

A taxpayer cannot be denied initiation of mutual agreement procedure on the perceived abusive nature of the transaction. The fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement (see paragraph 26 of the OECD Commentary). Nor should it be denied on the ground that the issue is not susceptible to resolution because of the constitutional or other domestic law provisions or decisions, unless such genuine domestic law impediments clearly and unequivocally prevent the competent authority from resolving the issue in a way that avoids taxation of the taxpayer which is not in accordance with the convention.

25.6.19 Implementation of decisions

The decisions of the competent authority are binding on the tax authorities. The courts, however, are not bound [see *IRC v. Commerzbank* (1990) STC 285 (UK)]. The taxpayers are also not bound. Domestic law impediments could not be relied for not implementing an agreement as a part of the agreement procedure. The obligation of implementing such agreements is unequivocal.

25.6.20 Time Limit- No bar for the implementation

The time limit in the national laws of the Contracting States is not an impediment in the implementation of the agreement if mutually decided. Normally such time limit relates to assessment and adjustment of tax refunds. The agreement shall have to be implemented irrespective of limitation of time in the domestic laws in regard to matters which are subject matter of agreement.

25.6.21 Adverse Court's decision

The taxpayer may make a presentation to the competent authority, notwithstanding his having made a similar complaint to the domestic court for the redressal of his grievance. The competent authority is bound to decide if it finds merit in the presentation, without waiting for the court's adjudication. But before it decides, if the court's decision is available which is adverse to the taxpayer, the question arises whether the competent authority may not feel bound by and depart from that decision. That question may also arise in a case where the claim has been finally adjudicated by the court and the taxpayer may still wish to present or pursue the claim under the mutual agreement procedure.

Where the claim is made after the decision of the court, the claim may be presented to the competent authority of the other state asking that state to take measures for avoiding double

taxation. In other cases, the views are different. One view is that the competent authority may not be bound by the decision of the court while implementing the provisions of the Convention, on the ground that the latter overrides the domestic law in case of conflict and the competent authority is an authority under the Convention and acting there under in the implementation of its provisions. The other is that every authority falling within the jurisdiction of the court, be it administrative or judicial, is bound by it and the competent authority is not an exception.

25.6.22 Suit pending in court

In case, however, suit is pending in the court, the competent authority, in order to avoid head on collision with the possible adverse decision, may make implementation of a mutual agreement subject to:

- the acceptance of such mutual agreement by the taxpayer, and
- the taxpayer's withdrawal of his suit at law concerning the points settled in mutual agreement.

Source:

1. United Nations Model Double Taxation Convention between developed & developing countries – Article 25
2. OECD Model Tax Convention on Income and on Capital (Condensed version) Article – 25
3. Treaties on Double Taxation Avoidance Agreements by S. Rajaratnam – Article 25 (2015)
4. Indian Double Taxation Agreements & Tax Laws by D.P. Mittal – Article 25(2014)

26. Article 26 – Exchange of Information

26.1 General

Article 26 deals with the international exchange of information between the tax authorities of contracting states. Since international law does not allow a State to conduct a tax investigation in another State without its consent, this Article empowers both Contracting States to exchange information required under the tax treaties and the domestic tax laws. Its purpose is wider than mere tax compliance; it is also meant to counter tax evasion and avoidance. The Article excludes legal and administrative assistance in tax enforcement or in the collection of taxes.

Apart from helping international trade by avoiding double taxation for immediate benefit to the taxpayers having transactions in more than one State, double tax avoidance agreements can be used to prevent fraud or tax evasion. In fact, it has become customary to describe the Agreement not only for “elimination of double taxation” but also for “prevention of fiscal evasion” even in the title of the Agreement. Article 26 would provide for exchange of information in respect of taxes covered by the agreement. The Article makes it clear that the scope of this Article is not confined merely to information relating to residents. It further provides that such information would be entitled to the secrecy in the same manner as such secrecy may be ensured under the domestic law, access to such information being confined for tax administrators and courts for the purpose of assessment of income, collection of tax or enforcing recovery of tax or for

purposes of appeals regarding the same. Since enforcement has been specifically stated, it may be possible to get information even for purposes of prosecution of the taxpayer for tax evasion.

Article 26 embodies rules under which information may be exchanged to the widest possible extent, both to facilitate the proper application of the treaty and to assist the Contracting States in the enforcement of their domestic tax laws. Consequently, the obligation to exchange information under this Article should be interpreted broadly, and the limitations on that obligation should not be extended by analogy beyond their specific meaning. In particular, the Article should be understood to require the Contracting States to promote an effective exchange of information.

In a global economy, cooperation among nations on fiscal matters has become increasingly important, and the former reluctance of nations to concern themselves with the revenue laws of other countries has mostly disappeared. Article 26 provides a basis for the effective exchange of information between the Contracting States.

Although Article 26 imposes reciprocal obligations on the Contracting States, it does not allow a developed country to refuse to provide information to a developing country on the ground that the developing country does not have an administrative capacity comparable to the developed country. Reciprocity has to be measured by reference to the overall effects of a treaty, not with respect to the effects of a single article.

Article 26 was modified substantially in 2011, with a view to clarifying certain issues, expanding the scope of the Article, and limiting exceptions to the obligation to exchange information. In some cases, the changes made were not intended to be substantive, but rather were intended to remove doubts as to the proper interpretation of the Article. For example, the term, “necessary” in paragraph 1 was changed to “foreseeably relevant” to clarify the intended meaning of the prior language. In contrast, the change in that paragraph providing for an exchange of information with respect to taxes not mentioned in Article 2 was intended to be a substantive change. Another example of substantive change is the addition of paragraph 4, which removes the requirement for a domestic tax interest.

In some cases, the issue of whether a change made to Article 26 is intended as substantive or interpretative depends on the prior practices of the Contracting States. For example, in some cases, the addition of paragraph 5, which removes, *inter alia*, domestic bank secrecy laws as a basis for refusing to exchange information, may simply clarify the meaning of the limitations on the exchange of information contained in paragraph 3. In other cases, it may modify that paragraph substantively. The effect of the change depends in part on the particular prior practices of the Contracting States. The position taken in the OECD Commentary is that paragraph 5 is primarily interpretative with respect to treaties between its member States. This issue may be of particular importance in interpreting treaties that entered into force prior to the adoption of the 2011 changes to Article 26.

Although tax evasion is illegal and tax avoidance is not, both result in loss of revenue to the Government, and, by definition, both defeat the intent of the government in enacting its taxing statutes. Consequently, mutual assistance in combating tax avoidance is an important aspect

of mutual cooperation on tax matters. In addition, some forms of aggressive tax avoidance are so close to the line between avoidance and evasion that a Contracting State is unlikely to know for sure whether the information it is requesting deals with avoidance or evasion until after it obtains the requested information. Information on tax avoidance may be extremely useful to a Contracting State in its efforts to close possible loopholes in its taxing statutes.

The term “exchange of information” should be understood broadly to include an exchange of documents and an exchange of information unrelated to specific taxpayers and the provision of information by one Contracting State whether or not information is also being provided at that time by the other Contracting State. Contracting States may wish to use electronic or other communication and information technologies, including appropriate security systems.

The scope of exchange of information covers all tax matters without prejudice to the general rules and legal provisions governing the rights of defendants and witnesses in judicial proceedings. Exchange of information for criminal tax matters can also be based on bilateral or multilateral treaties on mutual legal assistance (to the extent that they also apply to tax crimes).

Article 26 provides in paragraph 6 that “the competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made”. This language authorizes the competent authorities to exchange information in at least three modes: exchange by specific request, automatic exchange, and other exchanges, understood to include spontaneous exchanges.

Nothing in the United Nations Model Convention prevents the application of the provisions of Article 26 to the exchange of information that existed prior to the entry into force of the Convention, as long as the assistance with respect to this information is provided after the Convention has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such information, in particular when the provisions of that Convention will have effect with respect to taxes arising or levied from a certain time.

The Committee of Experts has suggested some guidelines for arrangements regarding the implementation of appropriate exchanges of information. Those guidelines are in the form of an inventory of options available to the competent authorities. The inventory is not intended to be exhaustive or to impose any procedural obligations on a Contracting State. Instead, the inventory is a listing of suggestions to be examined by competent authorities in developing procedures for an effective exchange of information.

26.2 UN Model Convention- Article 26

The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws of the Contracting States concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. In

particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes. The exchange of information is not restricted by articles 1 and 2.

Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation: (a) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State; (b) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; (c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

If information is requested by a Contracting State in accordance with this article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

The competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made.

a. Paragraph 1 of Article 26 provides that:

The first sentence of paragraph 1 sets forth the basic obligation of the Contracting States concerning the exchange of information. It requires, subject to the limitations of paragraph 3, that the competent authorities. Exchange such information as is “foreseeably relevant” for the proper application of the Convention or for the administration or enforcement of their domestic tax laws, as long as taxation under those laws is not inconsistent with the Convention.

Prior to the 2011 changes to Article 26, the term “necessary” was used instead of the term “foreseeably relevant”. The view of the Committee and the OECD Commentary has been that these terms have similar, if not identical, meanings. That is, the term “necessary” is understood

to mean “appropriate and helpful”, not “essential”. In any event, whatever the phrase chosen, the requesting State is not obliged to demonstrate its need for the requested information before the obligation to provide that information arises.

The standard of “foreseeably relevant” is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to request information about a particular taxpayer that is highly unlikely to be relevant to the tax affairs of that taxpayer. Contracting States may agree to an alternative formulation of this standard that is consistent with the scope of the Article. For example, they might replace “foreseeably relevant” with “necessary” or “relevant” or “may be relevant” if those terms are understood to require an effective exchange of information. In the interest of conformity with the OECD usage, the Committee decided to adopt the term “foreseeably relevant”, although some members of the Committee preferred the term “may be relevant” on the ground that its meaning was clearer.

The information covered by paragraph 1 is not limited to taxpayer-specific information. The competent authorities may also exchange other sensitive information related to tax administration and compliance improvement; for example, they might provide information about risk analysis techniques or tax avoidance or evasion schemes. They may also share information they have obtained about aggressive or abusive tax avoidance schemes, such as those promoted by some international accounting firms. In addition, the competent authorities may exchange information relating to a whole economic sector (e.g. the oil, fishing or pharmaceutical industry, the banking sector, etc.) and not to particular taxpayers.

The scope of the obligation to exchange information is not limited by Articles 1 or 2. That is, the obligation applies not only with respect to information relevant to the proper application of the Convention or to the administration or enforcement of domestic taxes mentioned in Article 2, but also to all other domestic taxes, including subnational taxes.

Some members of the Committee expressed concern that sharing of information with respect to all taxes, particularly subnational taxes, might prove burdensome or might raise constitutional and political issues for them. They suggested that the obligation to provide information might be limited to taxes covered by the Convention, plus one or two important taxes, such as the value added tax (VAT). To accomplish that outcome, the following language might be substituted for paragraph 1:

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws of the Contracting States *concerning taxes covered by the Convention and [insert specific taxes]* of a Contracting State, in so far as the taxation there under is not contrary to the Convention.

The obligation to provide requested information applies whether or not the person, with respect to whom the information is requested, is a resident of either Contracting State or is engaged in economic activity in either Contracting State. For example, a Contracting State may request information about the bank deposits of an individual who is resident in some third State.

3.652 International Tax — Practice

The obligation imposed under paragraph 1 is for an effective exchange of information. A Contracting State may not avoid its obligations under paragraph 1 through unreasonable time delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange under paragraph 1.

The following examples will illustrate the scope of paragraph 1 above:

- i. In computing the taxable profits of a permanent establishment that is located in State A and has its head office in State B, State A may request information from State B about the expenses and profits of the head office and the dealings of the head office with other permanent establishments and associated companies;
- ii. Similarly, if an associated company, within the meaning of Article 9, is located in State A and another associated company is located in State B, then State A may request information from State B about the profits and expenses of the associated company located in State B and about the dealings of that associated company with any other associated companies and permanent establishments;
- iii. State A is attempting to impose a corporate income tax on an entity claiming to be a partnership. State A may request information from State B that would be helpful to it in properly classifying the entity for tax purposes, including information about the way the entity is classified for tax purposes by State B;
- iv. State A is being asked to provide to one of its residents a tax credit under Article 23 B for income taxes allegedly paid to State B. State A may request from State B information about whether the alleged payment of the tax actually occurred.
- v. A corporation resident in State A has companies located in State B and State C. State B believes that the company doing business in its territory has been skimming profits into the company located in State C. State B may request that State A provide it with information about the profits and expenses of the company located in State C. Domestic Law of State A obliges the parent company to keep records of transactions of its foreign subsidiaries.

b. Paragraph 2 of Article 26 provides that:

A contracting state cannot be expected to provide confidential financial information to another contracting state unless it has confidence that the information will not be disclosed to unauthorized persons. To provide the assurance of secrecy required for effective information exchange, paragraph 2 provides that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.

Of course, the information received under Article 26 would be useless, or nearly so, to the requesting State (the Contracting State requesting the information) if the prohibition against disclosure were absolute. Paragraph 2 provides that information received under Article 26 can

be disclosed to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes mentioned in paragraph 1. In addition, it is understood that the information may also be communicated to the taxpayer, his proxy or witnesses in a civil or criminal proceeding.

As stated above the information obtained can be communicated to the persons and authorities mentioned and, on the basis of the last sentence of paragraph 2 of the Article, can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. But this disclosure to the public does not mean that the persons and authorities mentioned in paragraph 2 are allowed to provide on request additional information received.

If either or both of the Contracting States object to information obtained under Article 26 being made public by courts, or, once the information has been made public in this way, to the information being used for other purposes, they should state this objection expressly in their Convention.

In general, the information received by a Contracting State may be used only for the purposes mentioned in paragraph 1. If the information appears to be of value to the receiving State for purposes other than those referred to in that paragraph, that State may not use the information for such other purposes without the authorization of the competent authority of the supplying State. That authorization should not be unreasonably withheld.

In some cases, a Contracting State may prosecute a taxpayer for tax evasion and also for an additional crime, such as money-laundering, that arises out of the same set of facts. In such circumstances, the receiving State may want to use the information provided for both purposes.

Similarly, the information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.

Contracting States wishing to broaden the purposes for which they may use information exchanged under this Article may do so by adding the following text to the end of paragraph 2:

Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorizes such use.

The disclosure should be limited to information necessary for those to fulfil their oversight duties. Such oversight bodies include authorities that supervise tax administration and enforcement authorities as part of the general administration of the Government of a Contracting State. Such sharing is permitted only if the persons engaged in oversight activities are subject to confidentiality requirements at least as strict as those applicable to tax administration and enforcement officials. The competent authorities may want to agree as to the bodies that constitute an oversight body within the meaning of this paragraph.

c. Paragraph 3. of Article 26 provides that:

It contains provisions that limit the obligation of the requested State under paragraph 1. The limitations provided in paragraph 3, however, may be superseded by the provisions contained in paragraphs 4 and 5. The provisions of paragraph 3, read in conjunction with the provisions of paragraphs 4 and 5, should not be read in a way that would prevent an effective exchange of information between the Contracting States. In addition, a Contracting State should disclose to the other Contracting State before it enters into a convention any specific provisions of its laws and administrative practice that it believes entitle it to avoid an obligation otherwise imposed by paragraph 1.

Paragraph 3 (a), subject to the limitations provided in paragraphs 4 and 5, contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. For example, if a requested State is not permitted under its laws or administrative practice to seize private papers from a taxpayer without court authorization, it is not required to make such a seizure without court authorization on behalf of a requesting State even if the requesting State could make such a seizure without court authorization under its own laws or administrative practice. The purpose of this rule is to prevent Article 26 from creating an unintentional conflict between a Contracting State's obligation under Article 26 and its obligations under domestic law.

Domestic provisions requiring that information obtained by the tax authorities be kept secret should not be interpreted as constituting an obstacle to the exchange of information under paragraph 3 (a) because the tax authorities of the requesting State are obligated under paragraph 2 to observe secrecy with regard to information received under this Article.

Paragraph 1 obligates a requested State to provide information with respect to all of the taxes of the requesting State, even if the requested State does not have a comparable tax. Paragraph 3 (a) does not remove the obligation to provide information relating to taxes that the requested State does not impose. For instance, a requested State cannot avoid its obligation to provide information helpful to the requesting State in the enforcement of its value added tax merely because the requested State does not have a value added tax. Of course, the requested State may avoid the obligation to supply such information if it cannot obtain that information under its normal administrative procedures, within the meaning of paragraph 3 (b).

The purpose of paragraph 3 (a) is to avoid traps for the unwary, not to create such traps. A Contracting State that believes that it is not required to obtain certain types of information on behalf of the other Contracting State because of its own laws or administrative practice (including the laws and administrative practice of its subnational governments) should disclose that position in writing prior to entering into a convention containing Article 26. It should also disclose the likely effects of that position on its ability to provide an effective exchange of information. For instance, if a Contracting State believes that one of its laws prevents it from providing the other Contracting State with information as to the beneficial owners of its resident companies or other juridical persons, it should give written notice of that position during the

negotiation of the convention, with an explanation of the impact of that law on its obligations in relation to mutual assistance. Depending on the facts and circumstances of the particular case, a failure to disclose may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations under paragraph 1.

A Contracting State that changes its laws or administrative practice after entering into a convention containing paragraph 3 (a) must disclose that change to the other Contracting State in timely fashion.

A Contracting State that wishes to expand the scope of the Limitation currently provided in paragraph 3 (a) might modify that paragraph as follows:

(a) “To carry out administrative measures at variance with the laws and administrative practice of that Contracting State or of the other Contracting State even if that Contracting State knows and fails to disclose that specific provisions of its laws or administrative practice are likely to prevent an effective exchange of information”;

Some countries are required by law to notify the person supplying information and/or the taxpayer subject to an enquiry prior to the release of that information to another country. Such notification procedures may be an important aspect of the rights provided under domestic law. In some cases, notification should help prevent mistakes. (e.g., in cases of mistaken identity) and should facilitate exchange.

A Contracting State that under its domestic law is required to notify the person who provided the information and/or the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance. Such information should be provided to the other Contracting State before a convention is concluded and thereafter whenever the relevant rules are modified. Depending on the facts and circumstances of the particular case, a failure to disclose may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations under paragraph 1.

Different countries will necessarily have different mechanisms for obtaining and providing information. Variations in laws and administrative practice may not be used as a basis for the requested State to deny a request for information unless the effect of these variations would be to limit in a significant way the requesting State’s legal authority to obtain and provide the information if the requesting State itself received a legitimate request from the requested State. For instance, a Contracting State requested to provide information about an administrative ruling or advance pricing agreement (APA) it has granted cannot point to the absence of a ruling or APA regime in the requested State to avoid its obligation under paragraph 1 to provide such information.

Most countries recognize under their domestic laws that information cannot be obtained from a person to the extent that such person can claim the privilege against self-incrimination. A requested State, therefore, may decline to provide information if its self-incrimination rules preclude it from obtaining that information or if the self-incrimination rules of the requesting State would preclude it from obtaining such information under similar circumstances. In practice,

however, the privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. In the overwhelming majority of information requests, the objective is to obtain information from third parties such as banks, intermediaries, or the other party to a contract, and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

Information is deemed to be obtainable in the normal course of administration if the information is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons. For instance, if the requested State, as part of its audit policies, obtains information about the appropriateness of the transfer prices used by its taxpayers in dealings with associated companies, it is deemed to be able to obtain similar information about its taxpayers and associated companies on behalf of a requesting State.

It is often presumed, when a convention is entered into between a developed country and a developing country, that the developed countries will have a greater administrative capacity than the developing country. Such a difference in administrative capacities does not provide a basis under paragraph 3 (b) for either Contracting State to avoid an obligation to supply information under paragraph 1. That is, paragraph 3 does not require that each of the Contracting States receive reciprocal benefits under Article 26. In freely adopting a convention, the Contracting States presumably have concluded that the convention, viewed as a whole, provides each of them with reciprocal benefits. There is no necessary presumption that each of the articles, or each paragraph of each article, provides a reciprocal benefit. On the contrary, it is commonplace for a Contracting State to give up some benefit in one article in order to obtain a benefit in another article.

In general, a requested State may decline, under paragraph 3 (c), to disclose information that constitutes a confidential communication between an attorney, solicitor, or other admitted legal representative in his role as such and his client to the extent that the communication is protected from disclosure under domestic law.

The scope of protected confidential communications should be narrowly defined. Such protection does not attach to documents or records delivered to an attorney, solicitor, or other admitted legal representative in an attempt to protect such documents or records from disclosure required by law. Also, information on the identity of a person such as a director or beneficiary owner of a company is not protected from disclosure. Although the scope of protection afforded under domestic law to confidential communications may differ among States, the protection provided under paragraph 3 (c) does not extend so broadly so as to hamper the effective exchange of information.

Notwithstanding the provisions of domestic law in the requested State, that State may decline to supply requested communications between attorneys, solicitors or other admitted legal

representatives and their clients only if, and to the extent that, such representatives act in their capacity as attorneys, solicitors or other admitted legal representatives and not in a different capacity, such as nominee shareholders, trustees, settlors, company directors, or accountants, or under a power of attorney to represent a company in its business affairs. More specifically, the communication must have been produced in good faith for the purpose of seeking or providing legal advice or for use in existing or contemplated legal proceedings.

Paragraph 3 (c) also permits a requested State to decline to provide information if the disclosure of that information would reveal any trade, business, industrial, commercial or professional secret or trade process. 'Before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application. Secrets mentioned in this paragraph should not be taken in too wide a sense. A wide interpretation of the provision in many cases would be inconsistent with the purpose of Article 26 because it would render ineffective the exchange of information provided for in that Article.

A trade or business secret or trade process is generally understood to mean information which has considerable economic importance and which can be exploited practically and the unauthorized use of which may lead to serious damage (e.g. may lead to severe financial hardship). The purpose of the secrecy exception is to prevent an exchange of information from imposing unfair hardship on taxpayers by revealing to their competitors or potential competitors valuable secret information and thereby significantly diminishing the commercial value of that information. Secret information that once had substantial commercial value may be disclosed if that information does not have substantial commercial value at the time the information is requested. Information is not secret within the meaning of paragraph 3 (c) simply because the disclosure of it would embarrass the taxpayer or a third party or may result in the taxpayer having to pay additional taxes or losing income on account of bad publicity. A Contracting State may decide to supply requested information when it finds that there is no reasonable basis for assuming that the taxpayer involved may suffer adverse consequences incompatible with information exchange.

Secret information may be disclosed to the requesting State if the requested State determines that the risk of disclosure to the public or to competitors is unlikely due to the confidentiality requirements set forth in paragraph 2. A document that is protected from full disclosure because it contains protected secret information may be disclosed if the secret information is removed.

Financial information, including books and records, does not by its nature constitute a trade, business or other secret. In certain limited cases, however, the disclosure of financial information might reveal a trade, business or other secret.

Paragraph 3 (c) includes a limitation with regard to information that concerns the vital interests of the State itself. Under that limitation, Contracting States do not have to supply information the disclosure of which would be contrary to public policy (*ordre public*). This limitation should become relevant only in extreme cases. For instance, such a case could arise if a tax investigation in the requesting State were motivated by political, racial or religious persecution. The limitation may also be invoked when the information constitutes a State secret. For instance, there is no disclosure requirement when sensitive information is held by secret services, the

disclosure of which would be contrary to the vital interests of the requested State. Thus, issues of public policy (*order public*) rarely arise in the context of information exchange between treaty partners.

As discussed above, paragraph 3 may give a requested State the right to refuse to supply information under some circumstances. It is not required, however, to invoke any of the limitations of that paragraph. If the requested State declines to exercise its right under paragraph 3 and supplies the requested information, the information exchanged remains within the framework of Article 26. Consequently, the information is subject to the confidentiality rules of paragraph 2. In addition, the affected taxpayer or other third party has no ground for contending that the tax authorities in the requested State have failed to observe the obligation to secrecy imposed on them by domestic law.

d. Paragraph 4 of Article 26 provides that:

Paragraph 4 was added to the United Nations Model Convention in 2011. It is taken directly from the comparable provision of OECD Model Convention. According to paragraph 4, a requested State must use its information gathering measures to obtain requested information even though those measures are invoked solely to provide information to the other Contracting State. The term “information gathering measures” means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information. That is, a requested State does not need to have a domestic tax interest in obtaining the requested information for the obligation to supply information.

As stated in paragraph 4, the obligation imposed by that paragraph generally is subject to the limitations contained in paragraph 3. An exception applies, however, that prevents a requested State from avoiding an obligation to supply information due to domestic laws or practices that include a domestic tax interest requirement. Thus, a requested State cannot avoid an obligation to supply information on the ground that its domestic laws or practices only permit it to supply information in which it has an interest for its own tax purposes.

For many countries, the combination of paragraph 4 and their domestic law provides a sufficient basis for using their information gathering measures to obtain the requested information even in the absence of a domestic tax interest in the information. Other countries, however, may wish to clarify expressly in the Convention that Contracting States must ensure that their competent authorities have the necessary powers to do so. Contracting States wishing to clarify this point may replace paragraph 4 with the following text:

In order to effectuate the exchange of information as provided in paragraph 1, each Contracting State shall take the necessary measures, including legislation, rulemaking, or administrative arrangements, to ensure that its competent authority has sufficient powers under its domestic law to obtain information for the exchange of information, regardless of whether that Contracting State may need such information for its own tax purposes.

e. Paragraph 5 of article 26 provides that:

Paragraph 5 was added to the United Nations Model Convention in 2011. It is taken directly

from the comparable provision in the OECD Model Convention. Paragraph 1 imposes a positive obligation on a Contracting State to exchange all types of information. Paragraph 5 is intended to ensure that the limitation of paragraph 3 cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries, as well as ownership information.

Thus, paragraph 5 overrides paragraph 3 to the extent that paragraph 3 would otherwise permit a requested Contracting State to decline to supply information on grounds of domestic bank secrecy laws. Access to information held by banks or other financial institutions maybe by direct means or indirectly through a judicial or administrative process. The procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information.

Paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State has a law under which all information held by a fiduciary is treated as a “professional secret” merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information held by the fiduciary to the other Contracting State.

Paragraph 5 states that a Contracting State shall not decline to supply information solely because the requested information relates to an ownership interest in a person, which includes companies and partnerships, foundations or similar organizational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.

Although paragraph 5 limits the ability of a requested State to rely on paragraph 3 to refuse to supply information held by a bank, financial institution, a person acting in an agency or fiduciary capacity or to refuse to supply information relating to ownership interests, that paragraph does not eliminate all protection under paragraph 3. The requested State may continue to refuse to supply such information if that refusal is based on substantial reasons unrelated to the status of the holder of the requested information as a bank, financial institution, agent, fiduciary or nominee, or to the fact that the information relates to ownership interests.

A requested State is not necessarily prevented by paragraph 5 from declining under paragraph 3 (b) to supply information constituting a confidential communication between an attorney, solicitor, or other admitted legal representative and his client even if that person is acting in an agency capacity. To qualify for protection under paragraph 3 (b), however, a requested State must demonstrate that the communication between the attorney, solicitor, or other admitted legal representative and his client meets all the requirements of that paragraph, including that the communication is protected from disclosure under domestic law, that the refusal is unrelated to the status of the legal representative as an agent, fiduciary, or nominee, that any documents at issue were not delivered to the legal representative to avoid disclosure, and that non-disclosure would not frustrate an effective exchange of information.

Contracting States wishing to refer expressly to the protection afforded to confidential

communications between a client and an attorney, solicitor or other admitted legal representative may do so by adding the following text at the end of paragraph 5:

“Nothing in the above sentence shall prevent a Contracting State from declining to obtain or provide information which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative where such communications are protected from disclosure under paragraph 3 (b) and when the claim for protection under that paragraph is unrelated to the status of the legal representative as an agent, fiduciary, or nominee”.

The following example illustrates the application of paragraph 5:

An individual subject to tax in State A maintains a bank account with Bank B in State B. State A is examining the income tax return of the individual and makes a request to State B for all bank account income and asset information held by Bank B in order to determine whether there were deposits of untaxed earned income. State B should provide the requested bank information to State A.

f. Paragraph 6 of Article 26 provides that:

The language of paragraph 6 was taken, with some changes, from the last sentence of paragraph 1 of the United Nations Model Convention before its amendment in 2011. Paragraph 6 specifically grants to the competent authorities the authority to establish procedures for an effective exchange of information. The OECD Model Convention does not contain paragraph 6 or an equivalent. The position taken in the OECD Commentary is that this authority is implicit in Article 26.

To carry out the exchange of information in accordance with the preceding paragraphs of this Article, paragraph 6 provides that the competent authorities of the Contracting States shall work together to establish procedures for the exchange of information, including routine exchanges, typically in electronic form. Although paragraph 6 does not require them to make such arrangements in advance of the need for particular exchanges of information, this is strongly advisable to achieve an effective exchange of information.

Some States may wish to make explicit in their treaty that the competent authorities are obligated not only to exchange information on request but also to establish measures for automatic and spontaneous exchanges of information. Those countries may wish to add the following language to the end of paragraph 6:

“In addition to responding to specific requests for information, the competent authorities shall exchange information on a routine and spontaneous basis. They shall agree from time to time on the types of information or documents which shall be furnished on a routine basis.”

Some members of the Committee have expressed a concern that information requests from a developed country to a developing country could place excessive burdens on the tax department in the developing country, due to the different capacities of their tax administrations to obtain and provide information. That concern might be alleviated by making the requesting State

responsible for material extraordinary costs associated with a request for information. In this context, the question of whether an extraordinary cost of obtaining requested information is material could be determined not by reference to some absolute amount but by reference to the cost relative to the total budget of the tax department being asked to provide information. For example, a small absolute cost might be material for a tax department with very limited resources, whereas a larger absolute cost might not be material for a well-funded department.

Countries concerned about imposing substantial costs on developing countries might include the following language at the end of paragraph 6:

“Extraordinary costs incurred in providing information shall be borne by the Contracting Party which requests the information. The competent authorities of the Contracting Parties shall consult with each other in advance if the costs of providing information with respect to a specific request are expected to be extraordinary.”

26.3 Other Keynotes

a. Overall Factors

There are a variety of overall factors affecting the exchanges of information that the competent authorities will have to consider and decide upon, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. Such overall factors include those set out below:

Factors affecting implementation of exchange of information

These include the following:

- (a) The competent authorities should decide on the channels of communication for the different types of exchanges of information. One method of communication that may be provided for is to permit an official of one country to go in person to the other country to receive the information from the competent authority and discuss it so as to expedite the process of exchange of information;
- (b) Some countries may have decided that it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. Such an arrangement would presumably rest on authority, treaty or agreements other than that in the article on exchange of information of the envisaged double taxation treaty (although, if national laws of both countries permit, this article would be treated as covering this topic) and the arrangement would determine the conditions governing the presence of such representatives and their duties. In this regard, it should be noted that it would not seem necessary that the process be reciprocal, so that it would be appropriate for country A to have its representatives in country B but not vice-versa if country A considered the process to be useful and country B did not. If arrangements do exist for such representatives, then the competent authorities may want to coordinate with those representatives where such coordination would make the exchange of information process more effective and where such coordination is otherwise appropriate;

- (c) Some countries may decide that it is appropriate to have a tax official of one country participate directly with tax officials of the other country in a joint or “team” investigation of a particular taxpayer or activity. The existence of the arrangement for most countries would presumably rest on authority, treaty or agreements other than that in the envisaged treaty article on exchange of information, although, if national laws of both countries permit, this article could be treated by the countries as authorizing the competent authorities to sanction this arrangement. In either event, if the arrangement is made, it would be appropriate to extend to such an investigation the safeguards and procedures developed under the envisaged treaty article on exchange of information;
- (d) The process of exchange of information should be developed so that it has the needed relevance to the effective implementation of the substantive treaty provisions. Thus, treaty provisions regarding intercompany pricing and the allocation of income and expenses produce their own informational requirements for effective implementation. The exchange of information process should be responsive to those requirements;
- (e) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if there is an adequate informational base for the exchange of information process to support allowing one country to deduct expenses incurred in another country, then the treaty should be developed on the basis of the substantive appropriateness of such deduction;
- (f) The competent authorities will have to determine to what extent there should be cost-sharing or cost reimbursement with respect to the process of exchange of information.

b. Factors affecting structure of exchange of information process

These include the following:

- (a) It should be recognized that the arrangements regarding exchange of information worked out by country A with country B need not parallel those worked out between country A and country C or between country B and country C. The arrangements should in the first instance be responsive to the needs of the two countries directly involved and need not be fully parallel in every case just for the sake of formal uniformity. However, it should be observed that prevention of international tax evasion and avoidance will often require international cooperation of tax authorities in a number of countries. As a consequence, some countries may consider it appropriate to devise procedures and treaty provisions that are sufficiently flexible to enable them to extend their cooperation to multi-country consultation and exchange arrangements;
- (b) The competent authorities will have to weigh the effect of a domestic legal restriction on obtaining information in a country that requests information from another country not under a similar domestic legal restriction. Thus, suppose country A requests information from country B, and the tax authorities in country B are able to go to their financial institutions to obtain such information, whereas the tax authorities in country A are generally not able to go to their own financial institutions to obtain information for tax

purposes. How should the matter be regarded in country B? It should be noted that Article 26 here permits country B to obtain the information from its financial institutions and transmit it to country A. Thus, country B is not barred by its domestic laws regarding tax secrecy if it decides to obtain and transmit the information. Thus, it becomes a matter of discretion in country B as to whether it should respond, and may perhaps become a matter for negotiation between the competent authorities. It should be noted that many countries in practice do respond in this situation and that such a course is indeed useful in achieving effective exchange of information to prevent tax avoidance. However, it should also be noted that country A, being anxious to obtain information in such cases from other countries, should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries. It should be noted that a country that has entered into a tax convention that includes paragraph 5 of Article 26 of the United Nations Model Convention is required to provide information to its treaty partner notwithstanding its domestic bank secrecy laws;

- (c) In addition to situations involving the legal imbalance discussed above, the competent authorities will have to weigh the effects of a possible imbalance growing out of a divergence in other aspects of tax administration. Thus, if country A cannot respond as fully to a request as country B can because of practical problems of tax administration in country A, then might the level of the process of exchange of information be geared to the position of country A? Or, in general or in particular aspects, should country B be willing to respond to requests of country A even when country A would not be able to respond to requests of country B? This matter is similar to that discussed in the preceding paragraph and a similar response should be noted;
- (d) It should be noted that Article 26 authorizes a transmitting country to use its administrative procedures solely to provide information to the requesting country, even when the person about whom information is sought is not involved in a tax proceeding in the transmitting country. Moreover, the transmitting country should, for the purpose of exchange of information, use its own administrative authority in the same way as if its own taxation were involved;
- (e) The competent authorities will have to weigh the effect on the process of exchange of information of one country's belief that the tax system or tax administration of the other country, either in general or in particular situations, is discriminatory or confiscatory. It may be that further exploration of such a belief could lead to substantive provisions in the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate a process of exchange of information. One possible example of this is the treatment of non-permanent residents;
- (f) The competent authorities will have to weigh the effects that the process of exchange of information may have on the competitive position of taxpayers of the countries involved. Thus, if country A has a treaty with country B providing for exchange of information, country A will have to weigh the effect on the structure or process of that exchange of the

fact that country C does not have a treaty with country B, so that firms of country C doing business in country B may be subject to a different tax posture in country B than firms of country A. Similarly, even if a treaty with an exchange of information article exists between countries C and B, if the tax administration of country A has more authority to obtain information (to be exchanged with country B) than does the tax administration of country C, or is otherwise more effective in its administration, and therefore, has more information, then a similar difference in tax posture may result. As a corollary, it seems clear that the adequate implementation of exchange of information provisions requires a universal effort of tax administrations to obtain and develop under national laws a capacity for securing information and a competence in utilizing information that is appropriate to a high level of efficient and equitable tax administration.

c. Periodic consultation and review

Since differences in interpretation and application, specific difficulties and unforeseen problems and situations are bound to arise, provision must be made for efficient and expeditious consultation between the competent authorities. Such consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.

d. Limitation

Sub-paragraph 2 of the Models provides that the information required may not be one, which would exceed the jurisdiction or the practice under the domestic law or which may not be otherwise obtainable under such law. It further provides that the provision for exchange of information under the double tax avoidance agreement cannot be used for demanding information, which would violate the trade necessity and secrecy as regards the business or industry or any information relating to process or such information as would be contrary to public policy.

The Article not only confers right to participating State to get information but also places constraints against possible abuse of this article by placing curbs on any requisition for information not strictly required for purposes of domestic law, and which infringes on the rights of the taxpayer to protect his commercial rights like patents, trademarks, manufacturing and other processes.

e. Power for cross-border enquiry

The following may be some of the enquiries which may be covered by the Article:

- (1) Is the claimant to the relief as a bona fide resident of the other State in order, so as to make the agreement applicable to him.
- (2) The price at which the commodity is charged for the purpose of ascertaining whether the

transfer price is one at arm's length.

- (3) The relationship as between the company which actually trades with the State where relief is claimed and the actual supplier of the goods or services to ascertain the degree of association
- (4) What is the local price of the goods or services supplied to the claimant.
- (5) Information as to the actual source of goods or supplies, where the transactions are rendered through a tax haven so as to ascertain the proper transfer price.

It was realised that the Article is one which may be considered too wide and that it will be necessary to evolve methods and techniques apart from modalities for exchange of information between treaty partners. It is realised that the complexity of business transactions especially international ones would make it extremely difficult to get relevant information and that sophistication is required in identification of relevant information and exchange of the same. Improper manipulation of accounts to get treaty benefits is one which is targeted by this Article. It is realised that such exchange of information would be necessary only where such information is not possible of collection under the domestic law or such information is understood to have been withheld by the taxpayer.

It is also considered possible to evolve a system by which relevant information is automatically transmitted *suo motu* without any request from the other side. It may also be possible that where some manipulation has been detected by one treaty partner and such manipulation may be relevant in tackling avoidance or evasion in the other, such information may also be voluntarily given, because it is a matter of reciprocal assistance so that such voluntary exchange of information would provide hope for similar response from the other State.

Though this is an Article intended to transcend the shackles of sovereignty under which tax evaders take shelter, it is probable it is not put to use to such extent as may be possible or necessary for tackling evasions. If international co-operation is possible for tackling criminal offences as in the case of smuggling of narcotics or such other offences by the agency of Interpol, there is no reason why policing of tax evasion cannot be undertaken effectively by the use of this Article, so that the tax administration in one country can be used by the treaty partner in the other for tackling tax evasion.

f. Reasonable restraints

The restraints which are placed are reasonable in that no country can be vested with the power to get more information from the non-resident than what it would require from its own residents. Again what can be obtained in normal course should not be subject to enquiry or information under this Article. The measures used for getting the information should also be same as under domestic law. If domestic law would bar any information, which can be claimed to be secret for protecting one's trade, the agreement cannot be used for getting such information. This would mean that there should be comparable domestic law with the result that where such laws lack parity of powers, the lesser power as between treaty partners can alone be exercised under this Article. Not all of the States have uniform law as to the scope of this Article as will be evident

from different conventions.

g. Ambit of power not uniform

Some States would like to confine exchange of information only to the tax covered by the convention and strictly for purposes of administering double tax avoidance provision as is common in agreements, where Switzerland is a party. Some other States like United States would require the scope to be wider, so that tax evasion could be tackled on a world-wide basis. There has however, been a concern that such information should be obtained within the framework of the domestic law.

h. Protection for confidentiality

While exchange of information is considered to be a desirable part of any agreement, there is equally a concern for protection of confidential information travelling beyond immediate need to tackle tax evasion. The information required relates to tax though not merely the tax covered by the agreement.

There is also a reservation as to whether such exchange of information is permissible, when the sole purpose is for instituting criminal proceedings. But then a legitimate requisition for information has to be complied with. Any other view would place an unnecessary hurdle and would make the article for exchange of information unworkable. It is not for the State from which information is required to sit in judgement as to the scope of the use. It is certainly entitled to assume good faith and also respond to the same in the same good faith.

There have been some academic exercises by the UN as in a Paper in 1984 styled as "International co-operation in tax matters, guidelines for international co-operation against evasion and avoidance of taxes". A standard form of exchange of information has also been prepared by OECD. Some statistics furnished by US indicates that it has been active in responding to requests and has even received and sent information spontaneously. Experience of other countries especially India is not known but is unlikely to be significant.

i. A march towards a global society

India being a party to all the agreements, each of which provides for exchange of information except, where the agreement itself is limited to aircraft operations or shipping or such other activity, this part of such agreement, which has enormous scope for tackling the widespread evasion, in view of Indians having transactions abroad are known to practice, will be useful not only to collect evaded taxes but also prevent future diversion of such income outside the country. There has been large extent of under-invoicing of exports and over-invoicing of imports with considerable amount of Indian money siphoned off. Even some transnational corporations having business in India could not all be free from such evasion prompted not merely with a view to avoid income- tax and import duties, Industrial policy statement placing ceiling on foreign participation or ceilings on payments of commission etc. or exchange regulations placing restrictions on transfer of funds from India have also contributed to such malpractices. However, this provision has not been put too much use as is possible, but would open up a vista of possible action to tackle evasion hitherto not considered possible.

j. Future of application of this Article

This important aspect of exchange of information in any agreement should greatly help countries in tackling tax evasion but the limitations placed in some Agreements as regards collection of such information for fear of encroachment of sovereign powers of the State on one hand and the legitimate concern of a State for its own citizens to protect their trade secrets have been inhibiting factors in some Agreements. The investigation of fiscal offences in most countries is confined to the State with parallel machinery in the other countries not expected to be used. India has found its own experience difficult to enforce tax recovery of persons resident even in another Commonwealth country. It has not been able to obtain official information for a tax offence, as it is possible for criminal offences, where there is already agreement as by use of Interpol. Fiscal offences are not criminal offences in countries like France, so that legal assistance is not always possible outside the agreement.

Council of Europe has got a separate multilateral convention on mutual administrative assistance in tax matters. It provides not only for exchange of information but also simultaneous tax audits and assistance in collection of tax. The elaborate Article for exchange of information does not envisage the use of the power of one participant country for collection of the tax of the other country, so that tax is avoided once the non-resident ceases to have activity or assets in the country, where he is liable. The writ of no country runs beyond its territories and any attempt to recognize the right to collect tax dues in one country by the other is considered as a serious invasion of sovereign rights. This Article has to wait for better times, till countries understand that globalization necessitates facilities for cross-border investigation on a much larger scale including matters of recovery. But even the potential use of this Article for getting valuable information to tackle evasion has probably not been realised between most countries, so that it is possible for a taxpayer to get away from proper liability by withholding information even where such information is matters of record in one country but not made available in the other country.

Apart from all these factors, greater attention to sharing of information by providing a process by which information should be forthcoming, as a regular flow will alone serve the purpose of using the Agreement as an aid for prevention of fiscal evasion as effectively as elimination of double taxation.

26.4 Agreement on Exchange of Information on Tax Matters (TIEA)

Historical developments - The OECD in 1998 in a "Harmful Tax Competition: An Emerging Global Issue" report identified "the lack of effective exchange of information" as one of the key criteria in determining harmful tax practices. The OECD Global Forum Working Group (a loose institution formed in 2001 as a result of the OECD's Harmful Tax Practices Project. This Forum includes many tax havens and secrecy jurisdictions such as Bermuda, the Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino). was entrusted the task to develop a legal instrument that could be used to establish effective exchange of information. It developed 'Agreement on Exchange of Information on Tax Matters: The OECD Model TIEA, published in 2002, represents the effective exchange of information for the purposes of the OECD's initiative on harmful practices. The Agreement is presented as both multilateral instrument and a model of bilateral treaties or agreements. The

bilateral version is intended to serve as a model for bilateral exchange of information agreements. The Agreement comes into force on January 1, 2004 with respect to exchange of information for criminal tax matters and on January 1, 2006 with respect to other matters.

TIEA to promote international co-operation - The purpose of the TIEA is promote international co-operation in tax matters through exchange of information between two jurisdictions. Without such TIEA, it would not be possible for a tax jurisdiction to exchange or request information from other jurisdictions for tax purposes. A TIEA is an agreement between two jurisdictions and creates for both parties rights and obligations which are to be respected. It is not a treaty between two states but an agreement between two jurisdictions only for the purpose of exchange of information.

In order to ensure the implementation of domestic laws, countries are executing agreements (TIEAs) based on the above model, for the exchange of information. TIEAs are intended for use with countries for which a DTAA is not considered appropriate, mainly because they have no, or low, taxes on income or profits. While TIEAs are much narrower in scope than DTAAs, they are more detailed than DTAAs on the subject of information exchange. They specify the rules and procedures for how such information exchange is to occur.

India's Tax Information Exchange Agreement (TIEAs)

India has completed negotiations of new TIEAs with Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Jersey, Monaco, Saint Kitts & Nevis, Argentina, and Marshall Islands, out of 22 identified jurisdictions to facilitate greater exchange of information. The move is in line with the decision taken in G-20, which took up the issue of tax havens and tax evasions.

India and Bermuda signed a Tax Information Exchange Agreement to facilitate greater information exchange on potential cases of tax evasion. India's second information agreement with a popular tax haven after Bermuda is the agreement with Isle of Man. That agreement would provide banking and ownership information on companies besides exchange of past information in criminal tax matters. Information will have to be treated as secret and could be disclosed only to specified persons or authorities, which are tax authorities or the authorities concerned with determination of tax appeal. The agreement also has a specific provision that mandates that the requested party shall have to provide upon request the information even though that party may not need such information for its own tax purposes.

Recently India has taken proactive steps to combat the menace of illicit funds generated both as a result of tax evasion and corruption, as stated in a press release, dated 25-1-2011:

1. The issue of black money has attracted a lot of attention in the recent past. We would like to take this opportunity to share with you the proactive steps taken by our Government to combat the menace of illicit funds generated both as a result tax of evasion and corruption.

2. So far there are no reliable estimates of black money both inside and outside the country. The interim recommendations of BJP Task Force 2009 have estimated the amount of black money to be between USD 500 billion to USD 1,400 billion. A current study by Global Financial

Integrity has estimated the present value of illicit money outflow to be USD 462 billion. All these estimates are based on various unverifiable assumptions and approximations. Government has seized the matter and has constituted a multidisciplinary committee to get studies conducted to estimate the quantum of illicit fund generated by Indian citizens.

3. Government has formulated a five pronged strategy which consists of joining the global crusade against 'black money'; creating an appropriate legislative framework; setting up institutions for dealing with illicit funds; Developing systems for implementation; and imparting skills to the manpower for effective action.

Source:

1. United Nations Model Double Taxation Convention between developed & developing countries – Article 26
2. OECD Model Tax Convention on Income and on Capital (Condensed version) Article – 26
3. Treaties on Double Taxation Avoidance Agreements by S. Rajaratnam – Article 26 (2015)
4. Indian Double Taxation Agreements & Tax Laws by D.P. Mittal – Article 26(2014)

27. Article 27 – Assistance in the Collection of Taxes

27.1 Introduction

Earlier the Contracting States were hesitant to provide assistance in collection of taxes. The Organization for Economic Cooperation and Development ('OECD') introduced "OECD Mutual Assistance Convention" which provided for all forms of tax cooperation to tackle tax evasion and avoidance. This Convention was developed jointly by the OECD and the Council of Europe in 1988 and amended by Protocol in 2010. Presently, Article 27 forms part of the negotiated Tax Treaties.

Further, whenever negotiated, generally, the Contracting States prefer to negotiate the Article 27 based on the following factors as provided for in the UN Model commentary:

- (a) Domestic law in respect of assistance in the collection of other States' taxes;
- (b) Similarity in the tax systems, tax administrations and legal standards of the two States, especially in respect of protection of taxpayer's fundamental rights
- (c) Balanced and reciprocal benefits to both the States;
- (d) Efficiency of the tax administration;
- (e) Trade and investment flows between the two States;
- (f) Constitutional or other reasons limiting the taxes to which the Article can be applied.

It is pertinent to note that Article 27 does not provide any obligation on the Contracting State to carry out the administrative measures at the variance with the laws in practice and measures contrary to the public policy.

3.670 International Tax — Practice

Further, each paragraph of the Article deals with a different aspects under:

Paragraph 1: Scope of assistance in collection of revenue claims.

Paragraph 2: Definition of the term “revenue claim”

Paragraph 3: The extent of applicability of domestic tax laws provisions

Paragraph 4: Measures of Conservancy

Paragraph 5: Time limit and priority of the revenue claims

Paragraph 6: Proceedings before the administrative bodies

Paragraph 7: Procedure in case of change of situations

Paragraph 8: Limitations to the obligations imposed in respect of revenue claims

We shall now understand each of the aforesaid paragraphs in detail.

Paragraph 1: Scope of assistance in collection of revenue claims.

The first paragraph of Article 27 provides the scope and thereby casts an obligation on the Contracting State to assist the other Contracting State in collection of taxes owed to such State subject to fulfilment of the conditions prescribed in the Article. The conditions prescribed are generally mutually agreed between the Contracting States.

The paragraph further states that the assistance under this Article will not be governed by the restrictions provided under Articles 1 — 'Persons Covered' as well as under Article 2 — 'Taxes Covered' of the DTAA. Thus, the assistance will be provided irrespective the person being a resident or not within the meaning of the term “Resident” under Article 2 of the DTAA. But if the Contracting States wish to limit the assistance only the residents of either States then the same needs to be clearly stated and agreed in the DTAA.

The paragraph also suggest that the Contracting State should enter into agreement for deciding the practical application of this Article i.e. documentation to be accompanied (including translated documents), cost benefit analysis, etc. The said agreement should deal with the issue of anticipated cost to be incurred by the requested state in executing the request made by the requesting state. Ideally, the cost of collecting the revenue claim is charged to the assessee debtor. Thus, it is advisable to determine which state will bear un-recoverable cost. By default, the ordinary costs (i.e. cost directly and normally related to collection) are borne by the requesting state. As regard the extraordinary cost (viz. costs of experts, interpreters, translators, judicial bankruptcy proceedings, etc.), the agreement should define the term and also agree whether it will be reimbursed by the requesting state or not. In the agreement, the competent authorities may also deal with other practical issues such as:

- Time limit after which the assistance can no longer be made;
- Applicable exchange rate for conversion of the collected revenue claim;
- Procedure to remit the revenue claim; or

— Any minimum threshold below which assistance will not be provided.

Paragraph 2: Definition of the term “revenue claim”

As per the definition, "revenue claim" includes every kind of taxes that are imposed except the taxes contrary to the convention or any instrument in force between the contracting states. Accordingly, the term “revenue claim” cannot be restricted to the taxes covered under Article 2 of the DTAA. If such restriction is applicable, the same should be clearly provided and agreed. Same will be the case, if the Contracting States want to limit the term “revenue claims” for specific type of taxes only.

Further, if the competent authorities want to freely communicate with each other about the information of taxes, then the provisions of Article 26 on Exchange of Information appropriately drafted and agreed to between the Contracting States.

Paragraph 3: The extent of applicability of domestic tax laws provisions

The third paragraph on Article 27 deals with the enforceability of the revenue claim. The paragraph specifies that a request for assistance in collection can be made only if the requesting State has the right under its internal laws to collect the revenue claim and the person who owes the amount has no administrative or judicial rights to prevent such collection under the laws of such requesting state. Also, the assistance can be provided when the requesting state provides an official request along with all the requisite documentation to the requested state.

Further, if the requested State's internal law restrictions do not allow it to collect its own revenue claims due to pending appeals/ assessment, the paragraph does not authorise it to do so in the case of revenue claims of the other State in respect of which such appeal rights still exist (even though this does not prevent collection in the requesting State).

This paragraph also deals with the way in which the requesting state's revenue claim is to be collected by the requested state. The requested State is obliged to collect the revenue claim of the requesting state as if it were the requested State's own revenue claim even if, at the time, it has no need to undertake collection actions related to that taxpayer for its own purposes.

It is possible that the request may concern a tax that does not exist in the requested State. In that case, the requesting State shall indicate the details of the revenue claim viz. nature of the revenue claim, the components of the revenue claim, the date of expiry of the claim and the assets from which the revenue claim may be recovered. Based on the aforesaid information, the requested State will follow the applicable procedure to claim for a tax of its own which is similar to that of the requesting State or any other appropriate procedure if no similar tax exists.

Paragraph 4: Measures of Conservancy

This paragraph deals with taking measures to conserve the collection of tax when the liability is not due or when the Contracting State does not have a right to ask for assistance in collection. The measures of conservancy are subject to the Contracting States own domestic laws. The Contracting States have to determine if there is any need to include such measures in the DTAA.

Measures of conservancy can be applied to seizure of assets as well as bank guarantees before the final judgement when the debtor assests still has the right to prevent its collection. Thus, the assets shall be available subsequently whenever the collection will take place.

At the time of making the request for conservancy, the requesting state should provide the details of each stage of assessment or collection, so that the requested state can determine whether its own laws permit it to take the measures of conservancy. The details of assessment or collection would include the procedural phase in the requesting state and the amount anticipated to be collected.

Paragraph 5: Time limit for and priority of the revenue claims

Time limit for the revenue claims

This Paragraph states that the time limit of the requested state will be applicable to the revenue claims made in terms of paragraph 3 or paragraph 4. Thus, no objection based on the time-limits can be provided under the domestic laws of the requested State unless the paragraph 5 is amended to apply such limitations.

The Contracting States may also agree that after a certain period of time the obligation to assist in the collection of the revenue claim will expire.

The requesting state should ensure that the claim is enforceable in the requesting state. The period should run from the date of the original instrument permitting the enforcement.

Priority of the revenue claims

Further, the paragraph provides the rules of priority. The existing domestic rules of priority cannot be applied to the foreign revenue claims under this Article unless otherwise specified. Thus, the rules for requested states as well as requesting state for giving their own claim a priority over the claims of other creditors should not apply to revenue claims collected under Article 27.

In case the Contracting state want to provide the revenue claim of the other states with the same priority as is applicable to their own claim then the same needs to be clearly stated and agreed in the DTAA.

At this point of time, it is apt to know that the provisions of this paragraph do not apply to the application of general rules concerning time limits or priority which would apply to all debts (e.g. rules giving priority to a claim by reason of that claim having arisen or having been registered before another one).

Paragraph 6: Proceedings before the administrative bodies

The paragraph provides restriction in respect of legal and administrative proceedings to be undertaken at the requested State. The purpose of this Article is to ensure that the administrative bodies of the requested state should not investigate the matter in respect of the existence, validity and the amount of revenue claim owed by the tax payer. The administrative law of the other state should thus have full faith in the revenue claim requested by the requesting State

and should not have any question on the validity, existence and accuracy of amount. Hence, in case there are any issues on the existence, validity and the amount of revenue claim owed by the assessee, then it needs to be exclusively dealt in the state in which the tax liability arose.

Paragraph 7: Procedure in case of change of situations

Paragraph 7 deals with situations under which there shall be a change of the conditions under which request was made. The State which has made the request must instantly notify the other State of the changing conditions and situations. On receipt of such a notice, the requested State shall ask the requesting State to either suspend or withdraw the request. The suspension shall apply until such time the requesting State informs the other State that the conditions subject to which such request was made are again satisfied or it ultimately withdraws the request.

The failure to inform the requested state about the change of situation, in effect will give the right to compensation for the damages suffered against the requesting state. The requesting state will have to bear the compensation cost and pay the general cost incurred by the requested state post the change of situation. It is to be noted that the DTAA's generally do not provide any obligation to compensate the assessee and thus the same would be governed by the domestic tax laws.

Paragraph 8: Limitations to the obligations imposed in respect of revenue claims

The paragraph provides limitations to the obligations imposed on account of the request for the assistance in collection of revenue claims. The paragraph clarifies that Contracting State is not bound to go beyond its own internal laws and administrative practice in fulfilling its obligations under the Article. If the requesting State has no power under its domestic laws to take measures of conservancy, the requested State could decline to take such measures on behalf of the requesting State. Similarly, if the seizure of assets and provision of bank guarantee to satisfy a revenue claim is not permitted in the requested State, it is not obliged to seize assets or provide bank guarantee under the provisions of the Article. The requested state thus, can deny providing assistance in collection of revenue claims and the said state will not be considered to have failed in observing the provision of Article 27.

It is to be noted that providing assistance after the requested State's time limits have expired will not be considered to be at variance with the laws of the other Contracting State in cases where the time limits applicable to that claim have not expired in the requesting State.

The paragraph further provides limitation to carry out measures that are contrary to public policy. It also provides that the Contracting State is not obliged to satisfy the request if the other State has not pursued all reasonable measures of collection or conservancy available under its laws or administrative practice. Lastly, the paragraph gives right to reject the request bearing in mind the practical considerations. Say, a cost benefit analysis needs to be undertaken for determining whether the assistance can be undertaken. Thus, if the anticipated cost to recover the revenue claim of the requesting State exceeds the amount of the revenue claim then it would be appropriate to reject the request for assistance.

Apart from the above, at times, many contracting states prefer to add the paragraph which allows a State not to provide assistance if it considers that the taxes with respect to which assistance is requested are imposed contrary to generally accepted taxation principles. This paragraph is in fact found in the joint Council of Europe-OECD multilateral Convention on Mutual Administrative Assistance in Tax Matters.

27.2 Domestic Tax laws of India

Under the provisions of section 228A of the Act, the Central Government is granted powers to undertake action for the recovery of the taxes due, from a person who has any property in India, on behalf of other Contracting State with whom it has entered into DTAA. The law also provides the procedure to be followed by the jurisdictional Tax Recovery Officer where the said property is situated. Similarly, in respect of taxes due from the assessee who has property outside India, the Tax Recovery Officer is granted powers to inform the Board to take appropriate actions in terms of the DTAA for the recovery of the taxes from the said assessee.

Below is the provision of section 228A of the Act:

“Recovery of tax in pursuance of agreements with foreign countries.

228A. (1) *Where an agreement is entered into by the Central Government with the Government of any country outside India for recovery of income-tax under this Act and the corresponding law in force in that country and the Government of that country or any authority under that Government which is specified in this behalf in such agreement sends to the Board a certificate for the recovery of any tax due under such corresponding law from a person having any property in India, the Board may forward such certificate to any Tax Recovery Officer within whose jurisdiction such property is situated and thereupon such Tax Recovery Officer shall—*

(a) proceed to recover the amount specified in the certificate in the manner in which he would proceed to recover the amount specified in a certificate drawn up by him under section 222; and

(b) remit any sum so recovered by him to the Board after deducting his expenses in connection with the recovery proceedings.

(2) Where an assessee is in default or is deemed to be in default in making a payment of tax, the Tax Recovery Officer may, if the assessee has property in a country outside India (being a country with which the Central Government has entered into an agreement for the recovery of income-tax under this Act and the corresponding law in force in that country), forward to the Board a certificate drawn up by him under section 222 and the Board may take such action thereon as it may deem appropriate having regard to the terms of the agreement with such country.”

Practical Examples

Example 1²⁸²:

²⁸²www.taxjournal.com – 13 July 2012, page 21

The UK's general law principle of non-cooperation with foreign jurisdictions in the collection of taxes has been significantly eroded with the introduction of EU Directive 2010/24/EU, which imposes an obligation on the UK to assist any Member State of the EU in the recovery of tax debts, together with the joint Council of Europe/Organisation for Economic Co-operation and Development Convention on Mutual Administrative Assistance in Tax Matters and the UK's adoption of Article 27 of the OECD Model Tax Convention or similar debt recovery provisions in its double tax agreements. The UK's basic principle of non-cooperation is in reality a thing of the past.

Example 2:

In the above context, we also quote below an example from page 536 of the book "Tax Treaties: Building Bridges between Law and Economics" published by IBFD:

"In one case information was received from Germany that the taxpayer concerned was exempted from tax there because he was employed for more than 183 days in India. The Tax Treaty between Germany and India assigns the taxing rights to India in such cases. Germany spontaneously informed India that the taxpayer was granted exemption in Germany and that India had the right to tax. Since the address of the person in India was available, information was passed on to the field. It transpired that the person concerned had filed a return of income in India earlier without disclosing that income but when he got an inkling of the information with the Department, revised his return upwards. Irrespective of whether the person can be prosecuted or not, substantial revenue accrued to India because of the information. It may be added that this is only an indicative case and that there are more instances of the successful use of information from other countries like the United Kingdom, Japan, etc."

27.3 Peculiar Features of Indian Tax Treaties

Some of the Indian Tax Treaties do not contain the article on 'Assistance in collection of taxes'. For e.g.

India - Canada Tax Treaty

India - USA Tax Treaty

India - Singapore Tax Treaty

India - Germany Tax Treaty

India - Italy Tax Treaty

Some other Indian Tax Treaties containing the article on 'Assistance in collection of taxes' similar to the model commentaries are:

India - Belgium Tax Treaty

India - Denmark Tax Treaty

India - Ukraine Tax Treaty

India - Bangladesh Tax Treaty

28. Article 28 – Members of Diplomatic Missions and Consular Posts

28.1 Introduction

Article 28 of the United Nations Model Double Taxation ('UN Model') Convention deals with the members of diplomatic missions and consular posts. Thus, the article does not cover the officials of the organizations which obtain fiscal privileges through the organizations.

Article 28 of the UN Model Convention reads as under:

“MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.”

Article 28 of the OECD model relating to matters of Diplomatic Missions and Consular Posts, is identically worded as Article 28 of the UN Model and Article 27 of the US model.

28.2 Salient Features

28.2.1 This Article unlike the others does not deal with any tax matters. It is only to ensure that the members of diplomatic missions and consular posts are not denied special treatment under international law or under any other international agreement.

28.2.2 The Article does not independently provide any benefit to the members of diplomatic missions or consular posts as against other article viz. Article 19 on Government services. The Article is merely clarificatory in nature. It provides restriction on the applicability of the provisions.

28.2.3 The provisions of DTAA are not / less favourable to the members of diplomatic mission or consular posts then they have the right to avail the benefit under international law or under special international agreements. The members of diplomatic mission and consular posts can avail the benefit under Tax Treaty benefit or under international law or under special international agreements, whichever is more beneficial.

28.2.4 In case of any discrepancy under DTAA vis-à-vis under international law / special international agreements, the members of diplomatic missions or consular posts can opt for the higher benefits. The said Article prescribes about the rights for privileges. It however does not create new right for privileges.

28.2.5 The word privilege in generally neither defined under the DTAA nor under the domestic tax laws of India. Thus, the term needs to be understood in common parlance.

As per the dictionary meaning, the term “privilege” means:

- i. As per Webster's comprehensive dictionary privilege means a right or immunity granted as a peculiar benefit, advantage or favour or a peculiar or personal advantage or right especially when enjoyed in derogation of a common right.
- ii. As per the advanced law of Lexicon privilege means a special or peculiar benefit, favour, or advantage; a right or immunity enjoyed only under special conditions; a prerogative, franchise, or permission; the privileges of the rich.

Mainly, the fiscal privilege under the general international laws is found in Article 34 of the 1961 Vienna Convention on Diplomatic Relations and Article 49 of the 1963 Vienna Convention on Consular Relations. Beyond that the contracting state may agree to the term "fiscal privilege" under the provisions of the respective DTAA.

28.2.6 Privileged Persons

Reference can be made to the Vienna Convention to understand the persons who are granted privileges and the extent of such privileges.

The Vienna Convention on Diplomatic Relations grants different degrees of tax privileges, depending on the rank and function of the respective person. Generally, full privileges are afforded to the diplomatic agent. In this regard, reference is invited to following extracts of Article 34 of 1961 Vienna Convention on Diplomatic Relations and Article 49 of 1963 Vienna Convention on Consular Relations.

"A diplomatic agent shall be exempt from all dues and taxes, personal or real, national, regional or municipal, except:

- (a) *Indirect taxes of a kind which are normally incorporated in the price of goods or services;*
- (b) *Dues and taxes on private immovable property situated in the territory of the receiving State, unless he holds it on behalf of the sending State for the purposes of the mission;*
- (c) *Estate, succession or inheritance duties levied by the receiving State, subject to the provisions of paragraph 4 of article 39;*
- (d) *Dues and taxes on private income having its source in the receiving State and capital taxes on investments made in commercial undertakings in the receiving State;*
- (e) *Charges levied for specific services rendered;*
- (f) *Registration, court or record fees, mortgage dues and stamp duty, with respect to immovable property, subject to the provisions of article 23."*

"Article 49

Exemption from taxation

1. Consular officers and consular employees and members of their families forming part of their households shall be exempt from all dues and taxes, personal or real, national, regional or municipal, except:

- (a) *indirect taxes of a kind which are normally incorporated in the price of goods or services;*

- (b) *dues or taxes on private immovable property situated in the territory of the receiving State, subject to the provisions of article 32;*
- (c) *estate, succession or inheritance duties, and duties on transfers, levied by the receiving State, subject to the provisions of paragraph (b) of article 51;*
- (d) *dues and taxes on private income, including capital gains, having its source in the receiving State and capital taxes relating to investments made in commercial or financial undertakings in the receiving State;*
- (e) *charges levied for specific services rendered;*
- (f) *registration, court or record fees, mortgage dues and stamp duties, subject to the provisions of article 32.”*

The members of the family of the diplomatic agent, consular officers and consular employees are also entitled for the privileges as entitled to diplomatic agent, Consular officers and consular employees, as the case may be. Members of the administrative and technical staff of the diplomatic mission and consular post, along with the members of their families forming part of their respective households also enjoy the privileges and immunities. However, other staff only enjoys limited privileges.

Members of the service staff of the diplomatic mission and private servants of the members of the diplomatic mission are exempt from dues and taxes payable on the emoluments received by reason of their employment. Similarly, members of the service staff of consular post are exempt from dues and taxes on the wages which they receive for their services. Further, the private servants may enjoy privileges and immunities only to the extent admitted by the receiving State.

The term emolument includes salaries income. Pension amount may not be regarded as emolument to grant tax exemption. Thus, it is necessary to examine the meaning of term “emolument” for providing tax exemption in the respective states.

It is pertinent to note that the aforesaid fiscal privileges are available subject to the nationality and permanent residency of a person. Thus, the privileges may not be available if the diplomatic agent, Consular officers and consular employees and member of service staff, family member of the diplomatic agent/ of administrative and technical staff of the mission / Consular officers / consular employees is either national or permanent resident of the receiving State.

The term nationally is not defined under the Vienna Convention. Thus, the term needs to be adopted from the domestic tax laws of respective states. Even the term “permanent residency” is not defined under the Vienna Convention.

It is also pertinent to note that tax exemption to the aforesaid privileged persons is applicable during the term of the diplomatic period which begins from the time the person enters the territory of the receiving State to take up his post or from the instant the appointment is notified to the Ministry when such person is already in the said territory. Such exemption period ends when the person leaves the country on expiry of his term or on passing of a reasonable period

post the expiry of the term. In case of the death of a member of the mission, the members of his family shall continue to enjoy the privileges and immunities to which they are entitled until the expiry of a reasonable period in which to leave the country.

Moreover, no legal action can be taken against the privileged persons on account of security under civil and administrative jurisdiction.

28.2.7 Non-governmental organisation

The personnel from non-governmental organisations do not enjoy the privileges as laid down by this Article as they do not have the same legal standing as a governmental organization under international law.

28.2.8 Avoidance of double non-taxation

Further, it may happen that the application of the DTAA as well as general rules of international tax laws / provisions under special agreement may result in non-taxation of the income of the members of diplomatic missions or consular posts. Below example explains one of such situation:

- i. Mr. A, a diplomatic agent, is sent on a mission from India to USA.
- ii. Mr. A earns income from other sources (viz. dividend income) in India
- iii. As per the international law, Mr. A may not be liable to tax on dividend income in the USA. Further, under the provisions of the Tax Treaty, Mr. A may be regarded as resident of the USA and consequently granted exemption/ reduction from tax on the income in India.

Accordingly, to mitigate the said non-intended double non-taxation of the income of the members of diplomatic missions or consular posts the contracting states may insert additional provisions for the same in the Tax Treaty.

These tax privileges have an impact on residential status of the members of diplomatic missions or consular posts.

28.2.9 Residence in sending state

The Residential status of the members of diplomatic missions or consular posts is not determined under the article. Accordingly, the residential status of the members of diplomatic missions or consular posts will be determined under the provisions of Article 4 - Residence of the Tax Treaty.

Generally, the domestic tax laws of the contracting states prescribe that although the members of diplomatic missions or consular posts are sent abroad they will be regarded as residents of the sending contracting state under the domestic tax laws. The contracting states where such domestic tax law prevails may incorporate these provisions in the bilateral Tax Treaties to determine appropriate residential status and levy tax. The draft provision suggested in the Commentary is as under:

“Notwithstanding the provisions of Residence under Article 4, an individual who is a member of a diplomatic mission or a consular post of a Contracting State which is situated in the other

Contracting State or in a third State shall be deemed for the purposes of the Convention to be a resident of the sending State if:

- (a) *in accordance with international law he is not liable to tax in the receiving State in respect of income from sources outside that State or on capital situated outside that State, and*
- (b) *he is liable in the sending State to the same obligations in relation to tax on his total income or on capital as are residents of that State.”*

In view of the above, notwithstanding the provisions of Residence under Article 4 of the Tax Treaty, the member of a diplomatic mission or a consular post of India who is situated in USA shall be regarded as resident of India if:

- (a) in accordance with international law he is not liable to tax in USA in respect of income from sources outside India or on capital situated outside India, and
- (b) he is liable in India to the same obligations in relation to tax on his total income or on capital as are residents of India.

The members of diplomatic mission and consular posts are generally taxed comprehensively in the sending state and thus regarded as tax residents of sending state. However, if these members are taxed in respect of income other than remuneration from services in receiving state then they will be regarded as residents of receiving state. Consequently, it would be necessary to apply the tie-breaker test to determine the correct country of residence.

28.2.10 Honorary consular officers

This Article does not apply to honorary consular officers who avail any privileges to which they are not entitled under the general rules of international law (there commonly exists only tax exemption for payments received as consideration for expenses honorary consuls have on behalf of the sending State). Thus, the Contracting States may incorporate provisions in the Tax Treaty in respect of application of the Article 28 to honorary consular officers.

28.2.11 Domestic tax laws of India

In terms of the provision under Section 10(6) of the Income-tax Act, 1961, remuneration received as an official of an embassy, high commission, legation, commission, consulate or the trade representation of a foreign State or as a member of the staff of any of these officials, for service in such capacity is exempt from tax in India. The exemption remains valid only if such members of the staff are not engaged in any business or profession or employment in India otherwise than as members of such staff. The section further provides that the remuneration received as a trade commissioner or other official representative in India of the Government of a foreign State (not holding office as such in an honorary capacity) or as a member of the staff of any of those officials shall be exempt only if the remuneration of the corresponding officials or staff of the Government enjoys a similar exemption in that country.

28.2.12 Practical Examples

The Central Board of Direct Taxes vide its Circular no. 293 [F. No. 200/140/80-IT(A-I)], dated 10-2-1981 clarified that not only Salary but also pension (since being part of salary) received by

erstwhile employees of UN is exempt from tax. The relevant part of the Circular reads as under:

“181. Pension received by erstwhile officials of United Nations - Whether exempt from tax in view of section 2 of UN (Privileges and Immunities) Act, 1947

1. Section 2 of the UN (Privileges and Immunities) Act, 1947, read with section 18, clause (b) of article V of the Schedule thereto, inter alia, grants exemption from taxation to salaries and emoluments paid by the United Nations to its officials. The question whether pension received by the erstwhile officials of the United Nations from it would be exempt from income-tax was considered by the Karnataka High Court in the case of CIT v. K. Ramaiah [1980] 126 ITR 638. The High Court held that since, under section 17 of the Income-tax Act, salary has been defined to include pension, if salary is exempted from tax, so shall be the pension. The Board have accepted the decision of the Karnataka High Court.

2. In view of the foregoing, apart from salary received by employees of the UNO or any person covered under the UN (Privileges and Immunities), Act, 1947, pension received by them from the UN will also be exempt from income-tax. Pending appeals on this point may be conceded and reference applications withdrawn.”

28.3 Peculiar Features of Indian DTAA

India – UK tax Treaty:

Article 29 of the India - UK DTAA provides for the following additional clause on residence of the Diplomatic and Consular Officials which is not found in other Indian Tax treaties –

“2. Notwithstanding the provisions of paragraph 1 of Article 4 (Fiscal domicile) of this Convention, an individual who is a member of the diplomatic, consular or permanent mission of a Contracting State which is situated in the other Contracting State and who is subject to tax in that other State only if he derives income from sources therein, shall not be deemed to be a resident of that other State for the purposes of this Convention.”

India – Germany Tax Treaty

Article 27 of the India – Germany DTAA on ‘Diplomatic and Consular Privileges’ unlike other Indian tax treaties provides for applicability of the provisions of the article to members of international organisation.

29. Article 29 – Territorial Extension

29.1 Introduction

The OECD Model Convention of Article 29 reads as under:

“TERRITORIAL EXTENSION

1. This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically

excluded from the application of the Convention or], to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

2. Unless otherwise agreed by both Contracting States, the termination of the convention by one of them under Article 30 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.”

29.2 Salient Features

Salient features of the Article are enumerated below.

29.2.1 Structure:

The structure of Article 29 consists of two paragraphs under the OECD Model Convention dealing with the manner of territorial extension of the Tax Treaty.

29.2.2 Condition for extension

The condition required to be fulfilled for extension of a convention to any state or territory is that they must impose taxes substantially similar in character to those which the respective contracting state applies.

29.2.3 Extension permitted to

The tax treaty may be extended to either of the following:

- any part of the territory of contracting states which is specifically excluded from the application of the convention or
- to any state / territory for whose international relations the respective contracting states are responsible.

29.2.4 Method of extension

The tax treaty entered into between contracting states may be extended:

- In its entirety or
- With necessary modifications

29.2.5 Mode of extension

The tax treaty may be extended by either of the following modes:

- Exchange of diplomatic notes or
- Any other manner in accordance with the constitutional procedure of the contracting states

29.2.6 Territorial extension effective from

The territorial extension becomes effective from such date and subject to such modification and conditions including conditions as to termination as may be specified and agreed between the contracting states in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

29.2.7 Termination of territorial extension

Unless otherwise agreed by the contracting states, the termination of Convention by either of the contracting states under Article 31 (Termination) automatically terminates application of territorial extension to any of its states or territories to which it had been extended.

The Tax Treaty termination leads to expiration of the territorial extension and from such date onwards the territorial extension shall cease to be effective.

29.3 Territorial extension practical examples:

Practically, there have been instances where tax treaty between two states has been extended. It has been a practice to extend treaties to the dependent territories of the contracting states.

For example –

France - Sweden treaty (1936) was extended by a protocol in 1949 to apply between Algeria and Sweden. However, there was no provision for such an extension in the treaty but it included a statement that it did not apply to Algeria.²⁸³

The United States – United Kingdom tax treaty (1945) was extended to 20 United Kingdom dependencies in 1959. The territories included Aden, Antigua, Barbados, British Honduras, Cyprus, Dominica, the Falkland Islands, Gambia, Jamaica, Montserrat, Nigeria, Rhodesia and Nyasaland, St Christopher, Nevis and Anguilla, St. Lucia, St. Vincent, the Seychelles, Sierra Leone, Trinidad and Tobago and the Virgin Islands. However, the extension excluded the articles relating to interest (except that it applied to Rhodesia and Nyasaland), capital gains and the exemption from the United States accumulated earnings tax.²⁸⁴

The Tax treaty entered into between Pakistan and Thailand (1980) includes Article 27 that provides for territorial extension of the convention to any state or territory for whose international relations Thailand or Pakistan is responsible for.

The Protocol and tax treaty entered into between Argentina and United Kingdom (1996) includes Article 29 that provides for territorial extension of the convention to any state or territory for whose international relations United Kingdom or Argentina is responsible for.

29.4 Peculiar Features of Indian Tax Treaties

Certain peculiar features of Indian Tax Treaties are highlighted as under:

²⁸³ IBFD : Bulletin – Tax Treaty Monitor, June 2006

²⁸⁴ IBFD : Bulletin – Tax Treaty Monitor, June 2006

1. Article 29 of the India – Denmark Tax Treaty on Territorial Extension provides for extension of the convention to any part or territory of Denmark by way of a common agreement. The tax treaty as signed between India and Denmark in 1989 has been extended to the territory of Faroe Islands by a protocol entered into between the competent authorities. The reason that could be attributed to the territorial extension of the tax treaty would be that Faroe Islands operate as a self-governing state within the Danish realm. However, certain areas including foreign affairs remain within the responsibility of Denmark.
2. Article 28 of the India – Netherlands Tax Treaty provides for extension of the tax treaty to either or both of the countries of Aruba or the Netherlands Antilles. Such extension shall take effect from such date and subject to such modification and conditions including conditions as to terminations as may be specified and agreed in notes to be exchanged through diplomatic channels.

30. Article 30 – Entry into Force

30.1 Introduction

Article 29 of the UN Model Convention deals with the procedures for timing, effect and applicability of the DTAA.

Article 29 of the UN Model Convention reads as under:

“ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at _____ as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

(a) (In State A):

(b) (In State B):”

30.2 Salient Features of Article 29 are as under:

29.2.1 Article 29 is divided into two paragraphs. The first paragraph deals with entry into force of the DTAA and the second paragraph deals with the date from which the DTAA should be applicable.

30.2.1 Five – step process:

The coming into force of DTAA is a five step process as under:

1) *Treaty negotiations*

The initial step is the negotiations between two contracting states to determine the scope

and purpose of the DTAA.

2) *Signing of DTAA*

Once the treaty is negotiated and all the salient points are discussed and finalized, the final document is drafted. The next step is the signing of the DTAA by the representatives of the two Contracting States.

3) *Ratification of the Tax Treaty*

4) *Exchange of instruments of ratification*

Once the instruments of ratification are exchanged, the DTAA is said to enter into force, though the Contracting States may agree upon another specific date. If the Contracting States have not determined a specific date, then the DTAA shall have a binding effect from the moment of ratification.

5) *Implementation / assimilation of the DTAA into national law*

The next step is assimilation of the DTAA into domestic laws of the Contracting State. The DTAA has to become a part of the domestic law and then it is required to be ratified.

30.2.2 Three main dates:

There are mainly three dates that can be identified from the text of Article 29:

1. Date of signing
2. Date of coming into force
3. Effective date

Date of signing

This is simply the date on which the DTAA is signed by the representatives of the Contracting States.

Date of coming into force

The date of coming into force is different from the effective date. The date of coming into force shall be the date on which the binding effect of the DTAA applies on the Contracting State. This date is subject to the agreement of the Contracting states.

Effective Date

The effective date shall be the date from which the DTAA provisions are applicable to tax matters subject to the scope of the Tax Treaty. The effective date shall also depend on the domestic legislation i.e. when the DTAA is implemented / absorbed by domestic law.

The important point here is to distinguish between the date when the treaty enters into force and the date from which it takes effect. According to the Model Convention, the treaty enters into force upon ratification of the treaty by exchange of instruments of ratification. This will be the same day for both states. The treaty will take effect, however, on the dates specified in

Article 29(2). The treaty may well take effect on different dates in the two Contracting States (usually at the beginning of the fiscal year of each state) and may even take effect on different dates for different taxes. The treaty may also be retroactive in that it is deemed to have taken effect on a date prior to the ratification of the treaty by the Contracting States. Whether there can be retroactive application depends on the domestic law of the respective Contracting State. Generally, the Contracting States shall agree on an effective date which is more favourable for taxpayers.

Under the domestic tax laws of India, the provisions of the Income-tax Act give an authority to the Central Government to enter into DTAA with the foreign country/ specified territory for granting the tax reliefs. The said power to enter agreement requires the Central Government to notify in the Official Gazette to make the DTAA operative and effective. In this regard, it is necessary to thus understand the meaning of “notify in the Official Gazette”. D. P. Mittal’s Indian Double Taxation Agreements & Tax Laws with OECD Commentaries on Article on Model Tax Convention Volume 1 6th Edition provides as under:

“In most of the India statutes, there is a provision for the rules made being published in the Official Gazette. It therefore stands to reason that publication in the Official Gazette, viz., the Gazette of India is the ordinary method of bringing a rule of subordinate legislation to the notice of persons concerned -

Publication in Official Gazette – Publication in the Official Gazette means that the Gazette containing the notification is available in Public. Contextually speaking, ‘publication’ means more than mere communication. ‘Publication’ is the act of publishing anything, offering it to public notice, or rendering it accessible to public scrutiny, an advising of the public, a making known of something to them for a purpose – State of M.P v. Ram Raghbir Prasad Aggarwal AIT 1979 SC 888.

Mere publication in the Official Gazette does not make the notification effective if such a Gazette is not available to public. The publication of notification would be complete only when the Gazette containing it is made available to public – U.S Awasthi v. IAC [1977] 107 ITR 796 (All.) and Kishan Lal v. IAC [1983] 15 Taxmann 549 (All.). In the Kishan Lal’s case a registered sale deed in respect of a property was executed on 18-3-1974. A notice under section 169D(1) of the Income-tax Act, 1961 was printed in the Official Gazette dated 21-12-1975. Copies of the said Gazette were, however, made available to the public on 16-1-1975. On these facts, the Division Bench of the Allahabad High Court held, following its earlier decision in U.S. Awasthi’s case, that the publication of such a notice was complete only when the Gazette containing the notification became available to the public.”

From the above, it can be observed that the Central Government has to notify the DTAA in the Official Gazette of India for it to be operative and effective in India.

30.2.3 Deviation

Regarding Article 30 of OECD MC and Article 29 of the UN MC, there is not much divergence in the practice of contracting states and the existing divergences do not lead to any significant

differences compared to the effects of Article 30 of OECD MC and Article 29 of the UN MC.

30.2.4 Exchange of ratification instruments

The exchange of ratification instruments is not a standard procedure in all Tax Treaties. At times there can only be an exchange of notes containing that each Contracting State has completed the procedure as per domestic law. At times there may be a notification through diplomatic chords regarding tax ratification. None of this is a divergence from the OECD or UN Model Convention.

Certain practical examples of Entry into force are provided below:

(a) India – Malaysia DTAA

The new India – Malaysia DTAA was signed on 9 May 2012 and entered into force on the 26 December 2012.

The first double tax Agreement between India and Malaysia was negotiated during 1976 based on the League of Nations Draft Conventions and the OECD draft Convention, 1963. This treaty did not contain articles on 'Capital Gains' 'Independent Personal Services' and 'Other Income' leading to litigation time and again. As a result a new treaty was entered into between India and Malaysia which has travelled a long distance from the original form to overcome litigation.

(b) India – Malta DTAA²⁸⁵

Article 29(2) of the India- Malta DTAA (1994) provided that the agreement shall have effect for India 'for any fiscal year beginning on or after the first day of April of the calendar year next following that in which this agreement enters into force.' The DTAA entered into force from February 1995. The Kerala High court in the case of *Norasia Lines (Malta) Ltd vs DCIT (2005) 279 ITR 268* held that the term 'calendar year next following' was 1996 and 'the first day of April of the calendar year next following' was 1 April 1996. Consequently, the India-Malta Tax Treaty had effect in India only from fiscal year 1996-97 and not 1995-96.

(c) India – Singapore DTAA¹

The India-Singapore DTAA entered on 24 January 1994, taxed royalties at 15%. However, vide a protocol dated 29 June 2005, notified in India on 18 July 2005, Article 12(2) was replaced to lower the tax rate to 10%. The Bangalore Tribunal in the case of *Autodesk Asia Pte Ltd v DDIT*, held that the tax rate of 10% applied for the entire fiscal year 2005-06 and not just with effect from 18 July 2005.

(d) The India – USA DTAA of 1989 was notified on 20 December 1990 and therefore in view of Article 30(2)(a)(ii) of the India- USA DTAA the Convention was effective in the taxable year (previous year) beginning 1 April 1991 i.e. the taxable year immediately after the calendar year in which treaty was notified¹.

²⁸⁵ Page 1226 of *The law and Practice of Tax Treaties: An Indian Perspective*, second edition by Nilesh Modi

30.3 Peculiar Features of Indian Tax Treaties

India Germany Tax Treaty:

Article 28 of the India - Germany DTAA provides for the time of entry into force of the DTAA in Germany in case of taxes withheld at source on dividend, interest, royalties and fees for technical services. The other Tax Treaties do not specifically provide for dividends, interest, royalties and fees for technical services.

31. Article 31 – Termination

31.1 Introduction

The UN Model Convention of Article 30 reads as under:

“TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year _____. In such event, the Convention shall cease to have effect:

(a) (In State A):

(b) (In State B):

TERMINAL CLAUSE

NOTE: The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.”

31.2 Salient Features

Salient features of the Article are enumerated below.

31.2.1 Structure:

The structure of Article 30 consists of only a single paragraph under the UN Model Convention dealing with the manner of termination of the Tax Treaty.

31.2.2 Term of application

The Tax Treaty remains in force till it is terminated by one of the Contracting State. The States may decide that the treaty shall need to apply for a certain period of time before it can be terminated. The States may also decide to apply a terminated treaty after the expiration date for a certain period.

31.2.3 Period of termination

As per the UN Model Tax Convention, the Tax Treaty can be terminated by giving a notice of termination six months before the end of the calendar year. Such notice of termination has to

be delivered through diplomatic channels. The Contracting States may decide a certain period post which the termination may be allowed.

The Tax Treaty remains in force until it is terminated by either Contracting States. As may be reasonably decided between the Contracting States, the Tax Treaty may be in force before it can be terminated. The termination of the Tax Treaty is by means of a unilateral declaration of intent by the Contracting States. The notice of termination need not contain any reasons for the same. It only has to be in accordance with the specified requirements.

31.2.4 Method of termination

The Tax Treaty can be terminated by other different methods such as by mutual agreement to suspend the Tax Treaty, or entering into a new Tax Treaty will override the existing one. An interesting fact to note is that severance of diplomatic relations shall not terminate the Tax Treaty.

The Tax Treaty termination leads to its expiration and from such date onwards the Tax Treaty shall not be applicable.

31.2.5 Recall of notice given to withdraw

Once the termination notice is given by a Contracting State, the Tax Treaty is deemed to be terminated. Such declaration cannot be withdrawn afterwards to keep the Tax Treaty in force. A unilateral withdrawal of termination may not be possible. If both the Contracting States agree for the withdrawal, a new agreement can be recognized in respect of the Tax Treaty.

31.2.6 Limited period of application:

Some Tax Treaties can be made applicable only for a limited amount of time as may be mutually decided between the Contracting States. The Tax Treaty may expire if the same is not extended atleast six months prior to the defined expiry date.

31.3 Treaty Termination practical examples

Practically, there have been many instances when DTAA between two states have been terminated. Generally some reasons for termination of a tax treaty may range from need to include articles on specific income heads, curtail flow of money to tax neutral states/ jurisdictions etc. Due to the tax dispute with Nokia, the India- Finland DTAA was to be reviewed. Also, India revenue officials were seeking to rework the Limitation of benefits clause under the India-Mauritius Tax Treaty to prevent shell entities to route investment into India. Mauritius had become the main route through which FDI was pouring into India and accordingly came under scrutiny from the Indian tax authorities under allegations of treaty abuse.

In the case of Cyril Eugene Pereira, (239 ITR 650), the AAR dealt with application of lower rate of income-tax in respect of dividend and interest income arising in India in hands of an individual who is non-resident of India and claims to be resident of UAE. It was held that the individual cannot claim treaty benefit when there is no dual taxability. The individual is subject to tax only

in India and not in UAE in respect of the above income. The purpose of the DTAA is not to grant relief to the individuals from the burden of tax arising only in India. A question arose that why the provision in respect of capital gains, interest etc. exist in the DTAA. The AAR held that either state is entitled to terminate the treaty by way of notice in the manner laid down in Article 31 of the India- UAE DTAA. It further holds that since the agreements are expected to continue indefinitely, the agreement has tried to cover all sorts of eventualities including termination.

31.4 Peculiar Features of Indian DTAA's

Certain peculiar features of Indian DTAA's are highlighted as under:

Some treaties provide for a period during which treaty cannot be terminated e.g. India – USA and India – Germany DTAA's.

Article 29 of the India - Germany DTAA on Termination provides for the time when the termination shall take effect in India in respect of income as well as capital whereas other Indian Tax Treaties provide only for income.

Article 31 of the India - UK DTAA on termination provides for the date on which termination shall take effect not only in respect of income tax and capital gains tax as in other Indian DTAA's but also provides for Corporation tax and Petroleum revenue tax in the UK.

Glossary

Advance Pricing Agreement (APA)	Advance Pricing Agreement is a procedure to settle Transfer pricing issues by the taxpayer by negotiating with the competent revenue authorities for determination of 'arm length price' as per applicable transfer pricing methods before entering into a transaction(s).
Advance Ruling	To save the taxpayer from being saddled with uncertainty, an Authority for Advance Ruling has been set up which gives 'Advance Ruling' on Income Tax matters pertaining to an investment venture in India, in advance which are binding in nature.
Ambulatory Interpretation	It means interpretation of the Tax Treaty by the contracting States as per their respective tax laws prevalent at the time the treaty is being applied.
Base erosion and Profit Shifting (BEPS)	It refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to tax haven jurisdictions when there is no or insignificant economic activity to reduce corporate tax liabilities.
Capital Export Neutrality	The principle that investors should pay equivalent taxes on capital income, regardless of the country in which the income is earned.
Capital Import Neutrality	The principle that all investments within a country should face the same tax burden regardless of the residential status of the investor.
Consolidated Tax Regime	Consolidated Tax Regime is a system which treats a group of wholly owned or majority-owned companies and other entities (such as trusts and partnerships) as a single entity for tax purposes. Head entity of the group is responsible for all or most of the group's tax obligations.
Controlled Foreign Company (CFC)	A controlled foreign company is a corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners.
Distributive rule	The basic purpose of Distributive clause in Tax Treaties is to lay down principles on which basis will be decided the right of the jurisdiction to levy tax.
Double Non Taxation	It is a situation where an income is not taxed in either of the contracting states to a treaty by virtue of the right to tax being given to one state and the income being exempt in that state.
Double Taxation	Double taxation is the levying of tax by two or more jurisdictions on the same income, asset, or financial transaction, as the case may be.

G.2 International Tax — Practice

Double Tax Avoidance Agreement (DTAA)	A Double Tax Avoidance Agreement (DTAA) is essentially a bilateral agreement entered into between two countries, whose basic objective is to promote and foster economic trade and investment between them by avoiding double taxation.
Dual Residence	It is possible to be resident for tax purposes in more than one country at the same time. This is known as dual residence.
Dualist view	Dualists view emphasizes the difference between national and international law, and require the translation of the latter into the former. DTAA becomes part of the National Legal system by specific incorporation / legislation in case of Dualistic View. Accordingly International law has to be national law as well, or it is no law at all.
Economic and Juridical Double Taxation	Double taxation is juridical when the same person is taxed twice on the same income by more than one state. Double taxation is economic if more than one person is taxed on the same item.
Entry into force	Entry into Force is the effective date from which the provisions of various bilateral Tax Treaties will come into force as per applicable OECD, UN or US Model Tax conventions.
Exemption with progression method	It means income earned in the source Country, though considered as exempt, is included in total income in the Country of residence for purpose of determining effective tax rate.
Fiscal Residency	Fiscal Residency, also known as Tax Residence is a test determining status of Residence of a person (including Companies) for the purpose of levy of tax in a state depending on domicile, place of management, close connection, etc. A person can be Fiscal Resident of two states at the same time wherein Tie-Breaker rules need to be applied.
Force of Attraction Rule	It implies that if a Foreign Enterprise sets up a Permanent Enterprise in Source state, all income derived by the foreign enterprise whether through PE or not will be taxable in source state.
Host Country	The country where source of income is situated is known as Host country.
Instrument of Ratification	Instrument of Ratification refers to a notification issued by a state to its counterpart state that it has made necessary changes in its local laws pursuant to the treaty.
International Offshore Financial Centres (IOFCs)	International Offshore Financial Centres are those tax jurisdictions where bulk of financial sector activities are of non residents. It is characterised by large number of financial institutions majority of whose ownership is with non-residents not opened to meet local needs but because of tax havens, secrecy and anonymity.

Last Better Offer Approach	It is the approach which is used in the Arbitration process to moderate the position of the negotiators so that the likeliness of its acceptance increases.
Monist View	Monists view accept that the internal and international legal systems form a unity. International Law and National Law are part of the same system of Law and thus DTAA overrides domestic law.
Most Favoured Nation (MFN)	MFN clause is usually found in Protocols and Exchange of Notes to DTCs. This clause helps in avoiding discrimination amongst residents of different countries. Once this clause is part of a treaty, the residents of contracting states get equal treatment as was earlier given to resident of other states.
Mutual Agreement Procedure (MAP)	The process of resolution of tax disputes arising between contracting States (of a tax treaty) by the competent authorities thereof.
Non Discrimination Clause	It is a clause found in many Tax Treaties whose aim is to ensure that there is no discrimination between the local assesseees and foreign assesseees as far as taxation is concerned.
Permanent Establishment (PE)	A permanent establishment is a fixed place of business which generally gives rise to income in a particular jurisdiction. The term is defined in many income tax treaties. It is a fixed place of business through which the business of an enterprise is wholly or partly carried on.
Protocol	A protocol in essence is a Treaty entered into between two countries at a later point of time, which nevertheless forms an essential part of the Tax Treaty and can be referred to while applying the earlier treaty entered into between the countries.
Ring Fencing	It means to financially separate a company from its parent company to make it immune from Financial ups and downs of parent company.
Round Tripping	Round tripping is where money is routed back into the country by local investors through tax havens. The income is sourced in the same country where the shareholder is resident but the income passes through a company resident in another country for tax reasons.
Specific Anti Avoidance Rules (SAAR)	Specific Anti Avoidance Rules are provisions that identify with precision the type of transactions to be dealt with and prescribe against the tax consequences of such treatment.
Safe harbor rules	Safe Harbor rules are those which when followed for certain international transactions, relieve the taxpayer of much complications as arm length price declared by him under transfer pricing will be accepted by tax authorities.

G.4 International Tax — Practice

Shell/ Conduit company	Conduit Company is a company which is set up in connection with a tax avoidance scheme. Whereby income is paid by a company to the conduit and then redistributed by that company to its shareholders as dividends, interest, royalties, etc.
Stateless person	A person who is not considered as a 'national' by any State under the operations of its law.
Static Interpretation	It means interpretation of the Tax Treaty by the contracting States as per their respective tax laws prevalent at the time of signing of treaty.
Switch over clause	It is a clause in a Tax Treaty to facilitate switching over by a taxpayer for foreign tax credit from exemption method to the credit method essentially to avoid Double Non Taxation.
Tax Equity	It implies that Each country whether being a country of Residence or a country of source must be entitled to its fair share of revenue. Also, taxpayers involved in cross border transactions must neither be saddled with additional levy of tax nor be given any undue concessions which results in discrimination.
Tax Information Exchange Agreement	Tax Information Exchange Agreement is a bilateral or multilateral agreement which gives legal authority to the contracting states to exchange tax related information by tax jurisdictions with the counterparts which was otherwise not possible.
Tax Inversion	Tax inversion means relocation of a company's legal domicile to a lower - tax nation, usually while retaining its material operations in its higher-tax country of origin.
Tax Residency Certificate (TRC)	It is a certificate issued by the government of a state to which a person belongs containing certain details concerning his or her residential status for claiming the benefit of any Tax Treaty in source state.
Tax Sparing Clause	Under the Tax sparing clause there is a provision where a country applies a tax credit against taxes owed on foreign income which is equivalent to the tax exemption provided by the foreign country.
Tax Terrorism	A situation where tax officials take undue advantage of powers conferred upon them for discharging their functions.
Tax Treaty	Government - to- Government agreement to prevent Double Taxation and Tax evasion by the resident of one country earning an income in the other.
Thin Capitalisation	A company is said to be thinly capitalised when its capital is made up of a much greater proportion of debt than equity, i.e. its gearing, or leverage, is too high. Also, the debt portion is financed by the parent co. and the purpose is to minimise tax expenses and nothing else.

Tie-Breaker Test	It is a test which is used to determine the predominance situation in cases where a person becomes fiscal resident in both the contracting states under a treaty.
Transfer Pricing (TP)	Transfer pricing refers to pricing the goods and services sold between associated and/ or controlled and/ or related legal entities within a group. It is the setting of the price for goods and services sold between controlled (or related) legal entities.
Treaty Shopping	The practice of structuring a multinational business to take advantage of more favourable tax treaties available in certain jurisdictions. For eg. a situation where a person, who is resident in one country (say the "home" country) and who earns income or capital gains from another country (say the "source" country), is able to benefit from a tax treaty between the source country and yet another country (say the "third" country).
Triangular Taxation	Triangular Taxation refers to a situation where tax incidence on a particular stream of income is typically triggered in three countries. Eg: A company resident of country A sets up a branch in country B which has some economic transactions generating income in country C.
Underlying Tax Credits	A method employed by a home country to provide fiscal incentives for outbound investments by home-based multi-national companies in which the total tax cost on foreign dividends is capped at the level of the home country's corporate tax rate.
Unilateral (Tax) relief	It refers to the relief scheme which can be provided to the tax payer by home country irrespective of whether it has any agreement with other countries or has otherwise provided for any relief at all in respect of double taxation. The purpose is to eliminate cascading effect of double Taxation.