Important Concepts in International Taxation

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In today's scenario where the corporations are going global, the need to understand international tax aspects cannot be over emphasized. More importantly, understanding international taxation aspects enable corporations to analyze their international transactions and build global business empires on a strong base so as to ensure that these empires do not crumble under the burden of heavy taxes. This article provides a brief note on some important concepts in international taxation and here it goes –

1) Double taxation in cross border transactions

A taxpayer entering into a cross border transaction may be liable to be taxed in his home country (i.e. the country of his fiscal residence) on his world income. This is generally known as the 'residence rule' of taxation. He may also be taxed in the country from which he earns income even though he is not a resident of that country. This is referred to as the 'source rule' of taxation. The purpose of Double Taxation Avoidance Agreements between two nations is mainly to avoid such economic double taxation. A. Mckie said, at the 22nd Tax Conference of the Canadian Tax Foundation "The taxpayer hopes the treaty will prevent double taxation of his income; the tax gatherer hopes the treaty will prevent fiscal evasion; and the politician just hopes". [Source: *Double Taxation Conventions and International Tax Laws - A manual on the OECD Model Tax Convention on Income and on Capital of 1992, by Philip Baker, 2nd Edition, page 10]*

2) 'Pacta sunt Servanda' principle

The Vienna Convention on the Law of Treaties has noted, in its preamble that the principle of *pacta sunt servanda* is universally recognized. The Convention incorporates this principle, in Article 26, in the following words:

> "*Every treaty in force is binding upon the parties to it and must be performed in good faith*"

In his book titled "The Modern Law of Treaties", published in 1974, the then Chief Justice of Nigeria has explained that:

> "*The requirement of good faith is a legal principle underlying the maxim. This must be so since customary international law, it is generally agreed, has a consensual basis, and normal international intercourse would be impossible without mutual confidence that obligations undertaken in the course of it will be fulfilled. If this is true of customary international law, it is even more so of conventional international law, both ancient and modern. States would hardly be encouraged to enter into treaty relations with one another if they could not assume from the outset that the treaty in question would be kept by the other parties to it.*"

Article 51(1)(c) of the Constitution of India provides that "*The State shall endeavour to foster respect for international law and treaty obligations in the dealings of organised peoples with one another;*"

Thus, in view of this principle, international tax treaties, like any other international treaty, are binding and the government, which is a party to a treaty, cannot, generally, deny any benefits that are available to a taxpayer under the treaty.

However, in India, the domestic taxation laws have been amended providing for the "Treaty Override" (this concept refers to circumstances where the domestic law of a country takes precedence over a treaty which such country has entered into with another) if the General Anti-Avoidance Rules provided under Chapter X-A of the Income-tax Act, 1961 are invoked. In simple words, the General Anti-Avoidance Rules would be applicable to the assessee, even if they are not beneficial to him as compared to the treaty provisions.

3) Who can access a tax treaty

A taxpayer, to be able to access a treaty, should necessarily be a 'resident' of at least one of the two countries of which the treaty is to be accessed. A detailed discussion is found in another chapter on the concept of 'resident'. There could be situations where a taxpayer is a resident of both the countries since the domestic tax law criteria for determining the residential status would differ from country to country. Tax treaties provide a mechanism to determine the residential status of such tax payers by applying, what is known as 'tie-breaker rule'.

Further, as per sub-section (4) of section 90 of the Act, the benefit of treaty cannot be availed by an assessee who is resident of a country outside India, unless he obtains a valid Tax Residency Certificate from the Government of that country. The Tax Residency Certificate should contain the following details –

a. Status (individual, company, firm etc.) of the assessee;
b. Nationality (in case of an individual) or country of incorporation or registration (in case of others);
c. Tax Identification Number or Unique Identification Number;
d. Period for which the residential status mentioned in the certificate is applicable;
e. Address of the assessee

If any of the above information is not provided in the certificate, the assessee would also be required to furnish Form 10F [Section 90(5) r.w. Rule 21AB].

4) Treaty Shopping

If only a 'resident' of one of the two states can access a treaty, a resident of a third country cannot, therefore, have any access to a treaty. However, when a resident of a third country, establishes an entity in one of the two countries that have entered into a treaty in order to take advantage of the provisions of that treaty, it is called 'treaty shopping'. In other words, treaty shopping is an arrangement whereby typically a person resident of a third State attempts to obtain indirectly the benefits that the treaty grants only to residents to the Contracting States. Such person is referred to in the international tax jargon as a 'conduit'.

The OECD Committee on Fiscal Affairs observed in their 1987 report that:

> "*Para 13. Normally under the OECD Model the conduit company is regarded as a person... resident in the State of the conduit... It is therefore entitled to claim the benefits of the treaty in its own name.*"
>
> "*Para 43. Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of 'pacta sunt servanda' even if considered to be improper.*"

The report thereafter discussed methods of combatting the use of conduits in international transactions.

The Indian Supreme Court, in one of the most celebrated judgments in the case of UOl vs. Azadi Bachao Andolan [2003] 263 ITR 706 (SC) held that the benefits of the Indo-Mauritius DTAA cannot be denied to a national of the third state who establishes a company in Mauritius in absence of any limitation clauses being incorporated in the treaty itself. The Apex Court held that the motives with which the residents of a third country have incorporated a company in Mauritius are wholly irrelevant and that the whole purpose of the Convention is to

ensure that the benefits thereunder are available even if they are inconsistent with the provisions of the Income-tax Act. The Court held that:

> "*...the treaties are entered into in a political level and have several considerations as their basis. Many developed countries tolerate or encourage "treaty shopping", even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to significant loss of tax revenue. The court cannot judge the legality of "treaty shopping" merely because one section of thought considers it improper. The court cannot characterize the act of incorporation under the Mauritian law as sham or a device actuated by improper motives."*

> "*If it was intended that a national of the third state should be precluded from the benefits of the Indo-Mauritius Double taxation avoidance convention, 1983, then a suitable term of limitation to that effect should have been incorporated therein. There are no disabling or disentitling conditions under the Convention prohibiting the resident of a third nation from deriving benefits thereunder. The motives with which the residents of a third country have been incorporated in Mauritius are wholly irrelevant. The whole purpose of the convention is to ensure that the benefits thereunder are available, even if they are inconsistent with the provisions of the Income tax Act. The principle of piercing the veil of incorporation cannot apply.*"

OCED members and G20 countries identified and developed 15 Action Plan to address Base Erosion and Profit Shifting ("BEPS") in a comprehensive manner. Various recommendations have been provided in Action 6 for preventing treaty abuse, which includes modification of the existing preamble, introduction/modification of limitation of benefit provisions and insertion of principal purpose test, in the bilateral tax treaties.

As a measure to combat treaty shopping, sub-section (2A) of section 90 of the Act also provides that General Anti-Avoidance Rules laid down under Chapter X-A would be applicable to the assessee, even if they are not beneficial to him as compared to the treaty provisions. The interplay between General Anti-Avoidance Rules under the Act and the unamended treaties as they stand at present is of course an area of concern and would certainly be a subject matter of litigation in the coming years.

5) Multilateral Instrument (MLI)

Implementation of BEPS measures would require changes to more than 3000 bilateral tax treaties, which could have taken decades and would also result into inconsistent implementation of BEPS measures. In view of the same a convention was conceived as a multilateral instrument for modification of the existing bilateral tax treaties in a synchronised and efficient manner, solely in order to swiftly implement the tax treaty-related BEPS measures. For this purpose, formation of an Ad-hoc Group for the development of such multilateral instrument was endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. India was part of the Ad-hoc Group of more than 100 countries and jurisdictions from G20, OECD, BEPS associates and other interested countries, which worked on an equal footing on the finalisation of the text of the Multilateral Convention, starting May 2015. The text of the convention and the accompanying explanatory statement was adopted by the Ad hoc Group on 24 November, 2016. India signed the MLI on June 7, 2017.

Basically, MLI is a multilateral treaty which will be applied alongside existing bilateral tax treaties modifying their application. These measures will prevent treaty abuse (Action 6), improve dispute resolution (Action 14), prevent artificial avoidance of permanent establishment (Action 7) and neutralise the effects of hybrid mismatch arrangements (Action 2).

MLI dwells on the concept of "*One Negotiation, One Signature, One Ratification*".

MLI modifies only a Covered Tax Agreement ("CTA"). CTA is a bilateral tax treaty which has been notified to the Depository by each of the contracting jurisdiction as a listed agreement under the MLI.

MLI provides the flexibility, to choose amongst alternative provisions in certain MLI articles, to apply optional provisions and in certain cases, to reserve the right to not apply MLI provisions. Each contracting jurisdiction is allowed to make a reservation unilaterally, while the effect of reservation applies symmetrically. Contrary to reservations, both contracting jurisdictions are required to choose to apply the same optional provision in order to apply the provision. However, MLI does not permit the jurisdictions to make treaty-by-treaty choices for MLI to affect and modify and thus, is not an à-la-carte instrument.

MLI modifies the application of the existing provision of the Covered Tax Agreement in different ways –

a.	'*in place of*'	:	replaces the existing provisions;
b.	'*applies to*' or '*modifies*'	:	changes the application of the existing provisions without entirely replacing it;
c.	'*in the absence of*'	:	added to the bilateral treaty if there is no existing provisions;
d.	'*in place of or in absence of*'	:	replaces existing provisions or added to the bilateral treaty if there is no existing provisions

While India is a signatory to the MLI and has also submitted its draft position on various provisions under MLI, the instrument is yet to be ratified. Hence, at present MLI is not in force in India and thereby cannot be read into the existing bilateral treaties.

6) Title and Preamble

The title and preamble form part of the context of the treaty and constitute a general statement of the 'object and purpose' of the treaty. They play an important role in the interpretation of the treaty.

According to the general rule of treaty interpretation contained in Article 31(1) of the Vienna Convention on the Law of Treaties, "*(a) treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.*"

BEPS Action 6 has recommended reformulation of the title and preamble of the treaties that will clearly state that the joint intention of the parties to a tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular through treaty shopping arrangements. Pursuant thereto clause (1) of Article 6 of MLI provides that a Covered Tax Agreement shall be modified to include the following preamble text:

> "*Intending to eliminate double taxation with respect to the taxes covered by this agreement 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 this agreement for the indirect benefit of residents of third jurisdictions),*".

Since Article 6(1) extracted above is a minimum standard, reservation is permitted only if the bilateral treaty already contains a preamble language describing the intent of the treaty to eliminate double taxation without creating opportunities for tax evasion or avoidance.

7) Limitation of treaty benefits ("LOB provisions")

Some treaties make specific provisions so as to ensure that the persons taking advantage of the treaty are, in substance, residents of one of the two contracting states. For example, Article 24 of the India-US treaty provides, *inter alia*, that the benefits of the treaty will be available to entities established in one of the two countries only if

it is beneficially owned (directly or indirectly) to the extent of at least 50% by individuals resident of one of the two states and are subject to tax in that state on their worldwide income. This ensures that the company taking the benefits under the treaty is substantially the resident of one of the two states. However, such provisions are not ordinarily found in all treaties.

Some of the treaties of India recently amended with respect of LOB include Mauritius, Singapore, Hong Kong, Kenya, Korea and Kazakhstan.

The LOB provisions in Mauritius and Singapore treaty are limited in scope as it affects only capital gains tax and no other benefits provided in the treaty. However, the other DTAAs listed above restrict the benefit of the treaty if the main purpose is to take advantage of the treaty.

Different objective tests are prescribed in different treaties, namely –

- ♣ The Publicly Traded Company Test
- ♣ Ownership/ Base erosion Test
- ♣ Active trade or Business Test
- ♣ Derivatives Benefit Test
- ♣ Main Purpose Test

The person failing to satisfy the tests prescribed in the treaty in this regard would be deprived from the benefits available under the treaty.

LOB rule is also one of the recommendations by BEPS Action 6 for preventing treaty abuse by limiting the availability of treaty benefits to entities that meet certain conditions based on the legal nature, ownership in, and general activities of the entity. The crux is that to avail the benefit of the treaty it should be ensured that there is sufficient link between the entity and its State of residence. The Action Plan provides for a 'simplified version' and 'detailed version' of the LOB and further recommends that the States should either have a detailed LOB or a Principal Purpose Test supplemented by a simplified LOB.

In lines with the recommendations of Action 6, Article 7 of the MLI provides for Principal Purpose Test and Simplified LOB. In the context of detailed LOB, the Explanatory Statement to MLI states that "*Given that the detailed LOB provision requires substantial bilateral customisation, which would be challenging in the context of a multilateral instrument, the Convention does not include a detailed LOB provision. Instead, Parties that prefer to address treaty abuse by adopting a detailed LOB provision are permitted to opt out of the PPT and agree instead to endeavour to reach a bilateral agreement that satisfies the minimum standard.*"

In its draft position on MLI, India has chosen to apply Simplified LOB.

8) Principal Purpose Test ("PPT")

The benefits of a tax convention should not be available where it is reasonable to conclude, having regard to all relevant facts and circumstances, that 'one of the principal purposes' of any arrangement or transaction is to secure a treaty benefit, unless it is established that obtaining that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the tax convention. This anti-abusive rule recommended under BEPS Action 6 as a minimum standard to address treaty related BEPS issues is known as the Principal Purpose Test or PPT.

PPT is a subjective test based on an assessment of the intentions behind a transaction or arrangement. This approach is similar to approaches taken under domestic anti-abuse rules or doctrines applied by countries around the world, such as general anti-avoidance rules or an 'abuse of laws' doctrine.

PPT forms part of the MLI and is dealt with under Para 1 of Article 7 thereto. PPT starts with a non-obstante clause and thus, would apply to the treaty in its entirety, thereby addressing cases of treaty abuse.

The suggested commentary on PPT under Action 6, which now finds place in 2017 edition of OECD Commentary (Condensed Version) explains that PPT supplements simplified LOB and does not restrict in any way the scope or application of LOB.

In order to determine whether the principal purpose is to obtain treaty benefit, the following points can be considered:

- ♣ Undertake an objective analysis of aims and objects of all persons involved in putting arrangement/ transaction in place;
- ♣ Why all of them are party to the arrangement of transaction?
- ♣ Conclusive evidence of the intent of the parties not required;
- ♣ Looking merely at the 'effect' not sufficient;
- ♣ All of the evidence must be weighed;
- ♣ Since PPT refers to reasonable conclusion, the possibility of different interpretations of the events must be objectively considered;
- ♣ Mere denial is not sufficient

Action 6 and the OCED Commentary provide for detailed guidance and illustrations to understand the scope and application of PPT.

Provisions similar to PPT are found in certain treaties as LOB rules. For instance, Para 2 of Article 29 of the Indo-Kenya DTAA dealing with LOB provides that "*A resident of a Contracting State shall not be entitled to the benefits of this Agreement if its affairs were arranged in such a manner as if it was the main purpose or one of the main purposes to take the benefits of this Agreement.*"

9) Beneficial Owner

Most of the treaties provide that the concessional tax treatment provided under the treaty would be available if the person concerned is the "beneficial owner" of the relevant income. This term is used in both the widely used Model Conventions ("MC"), namely, the OECD-MC and the UN-MC. However, it has not been defined in any of the MCs.

The concept of 'beneficial owner' was introduced in the OCED MC in 1977 in order to deal with simple treaty shopping situation. The OECDs continuous work on the clarification of the concept, finally resulted into changes in the OCED commentary on Articles 10, 11 and 12 through the 2014 Update.

In the context of dividend, the OCED Commentary provides that a recipient will be considered the beneficial owner of income he "*does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person*" (Para 12.4)

The learned author, Klause Vogel, in his book titled "Klause Vogel on Double Taxation Conventions", Fourth Edition, at 724 states that the beneficial owner is "*he who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields therefrom should be used or (3) both.*". After referring to various interpretation of the term, "*the author believes that the beneficial owner is a person who is the economic owner of the income (i.e. the recipient whose property has benefited from the income, taking into account all economically directly connected receivables and liabilities and related income streams*"

Under the domestic tax law as well, reference can be found to the term (not necessarily in verbatim) in sections like 2(18), 2(22)(e), 40A(2)(b), 79, etc. Recently, in the context of section 40A(2)(b), the Bombay High

Court in the case of **HDFC Bank Ltd. vs. ACIT [2019] 410 ITR 247** held that "*The word 'beneficial owner' needs to be construed in contrast to "legal owner" and not in the context of determining indirect ownership of shares. Hence, the emphasis is on covering the real owner of the shares and not the nominal owner.*"

Now, as per Article 3(2) of the MC, any undefined term under the tax treaties has the meaning that it has under the domestic tax law, unless the context otherwise requires. Vogel feels that "*the context requires that the term must be interpreted autonomously within the context of the treaty. Thus, the author's conclusion is that none of the domestic laws of the Contracting States is relevant for the interpretation of the term beneficial owner.*" However, the author does recognise that divergent views have been taken across countries on this subject.

However, in OCED Commentary (2014 and 2017 edition), the international nature of the term has been worded explicitly as under:

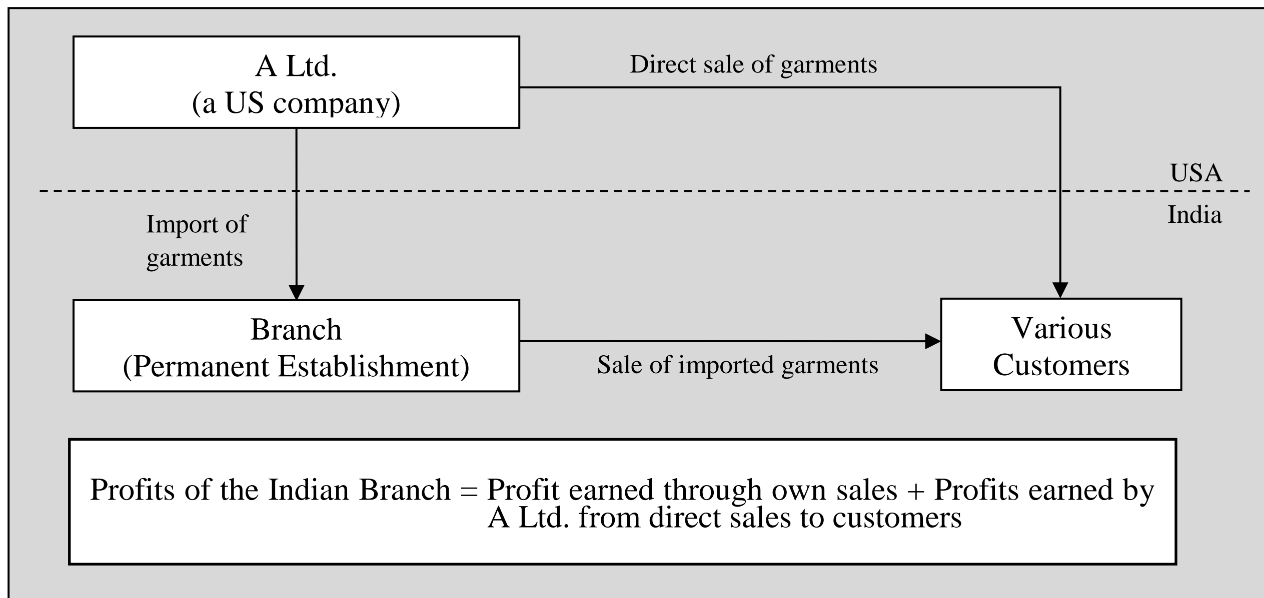
> "*12.1 Since the term "beneficial owner" was added to address potential difficulties arising from the use of the words "paid to…a resident" in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries), rather, it should be understood in its context, in particular in relation to the words "paid ... to a resident", and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.*"

10) Force of Attraction Rule

Generally as per the normal provisions, only the profits attributable to PE are taxable in the source country. However, in some Indian treaties, which are based on UN Model, there exist special provisions, which enhance the scope of attribution of profits to PE even if such PE has not performed any activities for business transactions effected by the foreign enterprise in the source country. This is known as Force of Attraction Rule ("FAR"). The basic philosophy underlying the FAR is that when an enterprise sets up a PE in another country, it brings itself within the fiscal jurisdiction of that other country to such a degree that such other country can properly tax all profits that the enterprise derived from that country – whether through the PE or not. However, current treaties have taken FAR only in limited and subdued form rather than in its pure form.

FAR provides that the profits earned by the enterprise would be attributed to the PE if such profits have arisen to the enterprise from direct sale of same or similar goods, as are effected through PE, or through other activities (say rendering of services) under same or similar circumstances in which its PE does.

Following example will further clear the picture:



FAR finds place in the treaties with Canada, Denmark, Italy, Mongolia, New Zealand, Poland, Spain, and USA.

11) Protocol

Protocol is an addendum to the treaty which elaborates or alters the text of the treaty. It is an indispensable and integral part of the treaty. Recently, in Ericsson Telephone Corporation India AB (India Branch) vs. DDIT (Intl. Taxn) [2018] 96 taxmann.com 258 (Delhi - Trib.) it has been held that a Protocol completes the treaty. If a particular benefit is being conferred, expanded or reduced by the Protocol, which is absent in the treaty, then the provisions of the Protocol shall apply *pro tanto*.

Klause Vogel at page 34 of his book referred above states that "*……..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.*"

12) Most Favoured Nation ("MFN") Clause

MFN clause in the context of DTAA is a non-discrimination principle whereby any concession or benefit granted by one contracting state to the treaty on certain items of income of a resident of the other contracting state will be granted conditionally or unconditionally on the same item of income of another contracting jurisdiction having the MFN clause.

In simple words, if India limits its taxation at source on certain items in its treaty with one country, India would extend the same benefit to other countries having the MFN clause and thereby the beneficial provisions can be read into the other treaties containing the MFN clause. An MFN clause can direct more favourable treatment available in any treaty only in regard to the same subject matter, the same category of matter or the same clause of the matter. For instance, MFN clause is available in India's treaty with France and Sweden.

MFN clause is generally introduced by way of a Protocol whereby it lowers the rate or narrows the scope

of income chargeable to tax in India and mainly covers income arising from dividend, interest, royalties and fees for technical service.

Depending upon the language used in the treaty, MFN clause may have an automatic effect or shall be subject to negotiation between the Governments of the two contracting states resulting into amendment in the treaty. For instance, whereas MFN clause under Indo-Switzerland DTAA is automatic *qua* 'lower rate of tax' on dividend, interest, royalties or fees for technical service provided in any other OCED member treaty after signature of the amending protocol on August 30, 2010, it is subject to negotiation between the Governments of India and Switzerland where any other OCED member provides a 'restricted scope' in respect of royalties and fees for technical services.

13) Transfer Pricing

This is yet another important concept in International taxation. When cross border transactions happen between two or more parties who enjoy special relationship, it is likely to structure their affairs in such a manner that one of them who resides in a high tax jurisdiction earns less than normal profits than the one who resides in a more favourable tax jurisdiction. Several developed and developing nations have adopted regulations in their domestic laws with a view to provide a deterrent against such tax avoidance practice. India also has introduced a separate chapter in its domestic law since 2001, namely Chapter X, which makes special provisions for determining taxable profits in international transactions between two related parties, technically known as 'associated enterprises'. The Indian law provides that profits arising from international transactions between two or more associated enterprises should be computed having regard to "arm's length price". Arm's length price is a price that is adopted in similar transactions between two or more unrelated parties.

The Indian transfer pricing provisions have evolved over the years with significant amendments in the recent years. In addition to the requirement of maintaining documents relating to the ownership structure, international transaction, arm's length price, etc., the provisions also require furnishing of Master File subject of satisfaction of certain conditions. Master File in intended to provide a blueprint of the Multi National Enterprise's global business operations and transfer pricing policies. Further, secondary adjustment provisions have been introduced to recover excess money from the associated enterprise where the transfer price is lower than the arm's length price. The excess money would be treated as an advance to the associated enterprise until its recovery and notional interest would be computed in the same.

Treaties normally do have special provisions for determining profits of Associated Enterprises and they too generally adopt the arm's length principle. Some treaties provide that if one of the countries have taxed its resident on an enhanced profits under the arm's length principle such that it has taxed the profits on which the second country has already charged tax, then the second country shall grant a corresponding relief to the other enterprise in computing its profits for taxation in that country. Such provisions are referred to as provisions for "corresponding adjustments".

14) Thin Capitalisation

Like transfer pricing provisions, thin capitalisation rules are found in many countries so as to provide a deterrent against artificial structuring of capitalisation with a view to create lower tax burden. The methods by which companies garner their capital affect the taxation of corporate income. Interest on loan is a tax-deductible expenditure, while dividend on shares is not. As a result of this, a tax payer in country "A" desiring to set up business in country "B", may opt for capitalising its business in such a manner that there is a higher debt and a lower capital flowing from the owners. As a result, the company in country "B" claims interest cost as tax deductible expenditure and the owner does not pay tax thereon (or pays nominal tax) in country "B". Domestic laws of some countries like France, Germany, Netherlands, etc., have formulated rules against such 'thin capitalisation' by providing some minimum capitalisation norms. Thus, thin capitalisation legislation is a tool used

by tax authorities to prevent what they regard as a leakage of tax revenues as a consequence of the way in which a company is financed.

The methods used to deal with thin capitalisation in various countries are:

- The fixed ratio approach;
- The subjective approach;
- The hidden profits distribution rules; and
- The 'no rules' approach.

BEPS Action 4 has recommended best practice approach with the intention to limiting base erosion involving interest deductions and other financial payments. The overview of the recommendations as diagrammatically provided at page 25 of Action 4 is as under:

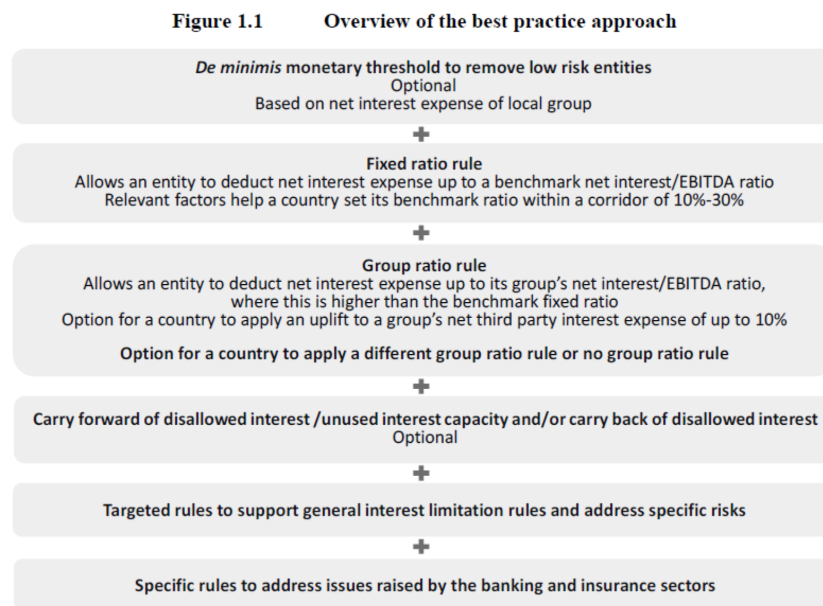


Figure 1.1 Overview of the best practice approach

In view of the recommendations under Action 4, a new section 94B has been inserted under the Act vide Finance Act, 2017 w.e.f. April 1, 2018 (i.e. AY 2018-19) to provide that interest expenses claimed by an entity in respect of debt borrowed from non-resident associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortisation (EBITDA) or interest paid or payable to associated enterprise, whichever is less. Other salient features of section 94B are –

a. Threshold : Section 94B applies only if interest incurred in respect of debt issued by non-resident associated enterprise exceeds ₹1 crore in the concerned year;

b. Deemed associated enterprise : If debt issued by a third party lender is either implicitly or explicitly guaranteed or a corresponding and matching amount of funds are deposited with the lender, by an associated enterprise, such debt shall be deemed to have been issued by an associated enterprise;

c. Carry forward of disallowed interest : Interest expense which is disallowed can be carried forward and set-off upto 8 immediately succeeding tax years;

d. Exclusion of any sector : Banking and insurance sectors are excluded from the scope of section 94B

15) Tax Sparing

Tax treaties provide for a mechanism by which the home country of a tax payer grants him credit in respect of the taxes paid by him in the source country in accordance with the provisions of the treaty. Generally, tax credit is so granted only if the tax is actually levied by the source country on the income earned there. However, at times, the source country provides for exemption in respect of certain income with a view to encouraging economic development of the country. As a result, no tax is actually levied on such exempt income. Yet, the home country agrees to provide credit against its tax of an amount equal to the source country tax that would have been paid in absence of such exemption. In other words, the benefit of tax exemption is effectively available to the taxpayer of, say, country ‘A’, if he participates in the economic development of country ‘B’. This is known as ‘tax sparing’, in the sense that country ‘A’ has spared its resident from paying tax on its income earned in country ‘B’ on the ground that country ‘B’ grants exemption on such income for encouraging its economic development.

The OECD’s Glossary of Tax Terms defines Tax Sparing Credit as “*Term used to denote a special form of double taxation relief in tax treaties with developing countries. Where a country grants tax incentives to encourage foreign investment and that company is a resident of another country with which a tax treaty has been concluded, the other country may give a credit against its own tax for the tax which the company would have paid if the tax had not been "spared (i.e. given up)" under the provisions of the tax incentives.*”

Tax sparing clause is found in treaties entered into by India with Bulgaria, China, Oman, Jordan, Malaysia Australia, Belgium, Bangladesh, Canada, Mauritius, Singapore, Spain, etc. While treaties with Bulgaria, China, Oman, Jordan and Malaysia have a general tax sparing clause without reference to any specific beneficial/exemption provision, treaties with other countries listed above provide for tax sparring credit only in respect of certain specified exemption provisions.

The Delhi High Court’s decision in PCIT vs. Krishak Bharti Co-Operative Ltd [2017] 395 ITR 572 (Delhi) [2017] provides an interesting reading as to the application of general tax sparing clause in the India-Oman DTAA. Article 25.4 of the said DTAA provides for tax sparing whereby India grants tax credit in respect of deemed tax on incentives provided in Oman that are designed to promote economic development. A question arose as to whether tax exemption on dividend income provided under the Oman law would qualify for such deemed tax credit or not. The High Court held that having regard to the letter addressed by the Omani Ministry of Finance to Oman Oil Company that the introduction of such exemption was to promote economic development in Oman the Indian investor was held entitled to the tax sparing benefit under the India-Oman DTAA. The tax department has filed a Special Leave Petition against the High Court’s order which has been admitted by the Supreme Court and is pending disposal.

16) Underlying Tax Credit

When a resident of Country 'X' earns dividend income from shares held in a company in Country ‘Y’, then Country ‘X’ taxes him on the dividend income but grants him tax credit in respect of the tax paid by him on dividend in Country ‘Y’. However, tax systems of some countries, like UK, presumes that the corporate tax paid by the company declaring the dividend is also, nothing but tax paid by the shareholders collectively and therefore, such countries grant tax credit to the shareholder on his *pro rata* share in respect of the taxes paid by the company on its profits out of which dividend is declared. Thus, the underling tax credit concept relieves the double taxation on foreign dividend income and the result would be that the shareholder would always pay the higher of the two taxes - the dividend distribution tax or the shareholder’s home country tax.

This concept is referred to as ‘underlying tax credit’ since, the credit is given for the tax paid by the underlying entity. This is also known as ‘Indirect tax credit’ method because shareholder receives credit for tax,

which it has only paid indirectly.

An illustration as to how the underlying tax credit method works is as follows:

Tax outflow (in Country Y)		Tax outflow for the shareholder (in Country X)	
Profits before tax	100	Dividend received	70
Tax @ *say* 30%	30	Corporate tax attributable	30
Net taxable profit	70	Dividend gross up	100
Dividend paid (assume entire)	70	Tax @ *say* 40%	40
Tax on dividend @ *say*10%	7	Credit for the underlying tax Credit for tax on dividend paid in Country X	30 7
Total tax in Country X (30+7)	37	Balance tax (40 – 37)	3

Such a provision is found, for example in the India-UK tax treaty under which a UK-company holding at least 10% shares in an Indian company is entitled to take credit in UK in respect of the corporate tax paid by the Indian company to the extent of the shareholder's interest on a proportionate basis. Some other treaties, which include this type of clause are treaties entered into by India with Australia, China, Ireland, Japan, Malaysia, Mauritius, Singapore, Spain, USA.

17) Mixer Companies

Generally, the foreign income rule requires that the credit for foreign tax against home country tax should be calculated on a source-by-source basis. Consequently, credits would be lost if home country company receives dividends from subsidiaries in countries where:

- ♣ the tax rate in a foreign country (say country A) is in excess of the home country rate or
- ♣ the tax rate in a foreign country (say country B) is lower than the home country rate.

In both the situations, there is a loss to the home country company since, in the first case, the tax credit on dividends would be limited to the amount of home country's tax payable on those dividends, and therefore, not all tax paid in A country be utilised (i.e. credited). In the second case too, the difference between the home country tax on dividends and the lower foreign tax will have to be paid.

In order to circumvent these restrictions, a so-called “mixer company” is used. These mixer companies (set up as intermediate holding companies) allow home country’s companies to “mix” high-taxed profits from overseas operating subsidiaries with low-taxed overseas profits. This enables the ultimate holding company in the home country to receive dividends from one source (the mixer company) with exactly the correct amount of creditable tax (a mix of high tax and low tax) attached to it and therefore, it avoids an additional home country’s tax charge on the low-taxed overseas profits. The intermediary company is set up at a place, which pays no tax on the dividends because they qualify for the ‘participation’ exemption, whereby dividends from significant shareholding in overseas companies are not taxed.

The only purpose of pooling (mixing) is to ensure that full credit is obtained for foreign taxes.

An illustration on how a mixer company works – HCO is the ultimate parent entity resident of State A which has a corporate tax rate of 33%. MCO, the mixer company is an immediate subsidiary of HCO and is a tax resident of State B. As per tax laws of State B, no withholding tax is required on dividend paid by MCO to HCO.

MCO receives dividend from Sub Co. 1 (no foreign tax paid)	100
MCO receives dividend from Sub Co. 2 (foreign tax of ₹ 66 paid)	100
Total dividend received by MCO	200
Foreign tax paid on dividend	66
Dividend net-off taxes	134
HCO receives dividend from MCO (Cash payment of ₹134 + Tax credit of ₹66)	200
Tax on dividend in State A in the hands of HCO: Corporate Tax @ 33% Less: Foreign Tax Credit Tax payable in State A	 66 (66) Nil
Tax payable in State A by HCO in the absence of MCO ♣ Dividend from Sub Co. 1 ♣ Dividend from Sub Co. 2	 33 Nil

18) Non-Discrimination

The non-discrimination clause in the tax treaties basically intend to prevent any discrimination between the tax treatments of two tax-payers on the basis of country of origin. Various types of non-discrimination clauses that can be found in the treaties are:

1. **Nationality based Non-Discrimination**: This seeks to ensure that no discrimination takes place on account of the nationality of a taxpayer in a host country. Thus, it establishes the principle that for purposes 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 the other Contracting State than the nationals of the latter State in the same circumstances. 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.

   Further, this concept is not restricted to only those nationals who are not residents of one or both of the Contracting States, 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 benefit of this provision as against the other Contracting State irrespective of the fact that they are not residents of either of the States but of a third State.

   The term 'national' is defined in the OECD-MC and UN-MC to mean:

   i. Any individual possessing the nationality [or citizenship] 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.

2. **Situs based Non-discrimination**: This seeks to end the 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** ("PE") in the other Contracting State. In other words, the taxation PE, 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.

   The purpose of this provision is to end all discrimination in the treatment of PEs as compared with resident enterprises belonging to the same sector of activities.

For example, in the case of **Metchem Canada Inc. vs. DCIT [2006] 100 ITD 251 (Mum Trib)** it was held that the restrictions on the deduction of head office expenditure of non-residents under section 44C would attract the non-discrimination clause under Article 24(2) of the Indo-Canada tax treaty and accordingly, the said restrictions would not apply in case of non-residents governed by the treaty having such non-discrimination clause.

In **Automated Securities Clearance Inc. vs. Income Tax Officer [2008] 118 TTJ 619,** the Pune Tribunal laid down the rule that the benefit of the non-discrimination clause would be available to the non-resident assessees only where the ground for the differentiation in treatment is considered to be ***unreasonable, arbitrary or irrelevant***. Accordingly, it was held that the benefit under section 80HHE of the Indian Income Tax Act would not be available to the PEs of non-residents carrying out similar business in India even though non-discrimination clause exists in the tax treaty.

However, in **Rajeev Sureshbhai Gajwani vs. ACIT (2011) 129 ITD 145 (Ahmd Trib)(SB),** it was held that, regardless of the specific wordings in section 80HHE referring to only Indian companies, the deduction under section 80HHE would be available even to PEs carrying on similar business in India as an Indian company in view of the non-discrimination article in the Indo-US DTAA. While rendering its decision, the Hon'ble Special Bench laid down the following principles in respect of the scope of the non-discrimination clause:

- If there are certain exemptions and deductions that are not available to a non-resident and would have been available to the non-resident had it been an Indian company, then it can be held that it is less favourably treated;

- For the application of article 26(2) of the Indo-USA treaty (which deals with the situs based non-discrimination), it is sufficient to show that the non-resident is engaged in the same business as the resident it is treated less favourably to. The different circumstances in which the business may be being performed is not to be considered; and

- There is no scope of reasonable differentiation for the purpose of applying the non-discrimination clause.

3. **Ownership based Non-Discrimination**: This seeks to ensure that the investment of foreign capital is not made disadvantageous to the entity in which the capital is so invested. This provision, and the discrimination, which it puts an end to, relates to the taxation only of enterprise, which is owned by foreigners, 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.

The Pune Tribunal in **Daimler Chrysler vs. DCIT [2009] 29 SOT 202** has dealt with a similar non-discrimination clause in the Indo-German DTAA and held that for the purpose of section 79 of the Act, subsidiaries of foreign companies should be treated at par with Indian owned subsidiaries. The relevant extract of the decision reads as under:

> *"We are of the considered view that the provisions of Section 79 read with Section 2(18), as they stood at the material point of time, were incompatible with the ownership non-discrimination provision set out in Article 24(4) of the Indo German tax treaty. The precise point of ownership discrimination was this. When an Indian subsidiary had an Indian parent company shares of which were listed on any recognized stock exchange of its domicile country i.e. India, the Indian subsidiary company was treated as a company in which public were substantially interested. However, when an Indian subsidiary company had a German parent company shares of which were listed in any stock exchange in its*

domiciled country, i.e. Germany, the subsidiary company was not given the status of a company in which public were substantially interested. There is no rational basis for this differentiation in treatment. The status of 'a company in which public are substantially interested' has important tax implications inasmuch as the disability of carry forward and set off of accumulated losses was not attracted in a case of a company in which public are substantially interested…. It is clearly a case of discrimination which is prohibited under Article 24(4) of the Indo German tax treaty……

….In view of the provisions of Article 24(4) of the Indo German tax treaty and in view of the preceding discussions, we are of the considered view that the disability on carry forward and set off of accumulated losses on account of change in shareholding pattern, under Section 79 r.w.s 2(18), cannot be extended to the Indian subsidiaries of German parent companies as long as German parent companies are listed on a German stock exchange recognized under their domestic laws. To this extent, the rigour of Section 79 must stand relaxed due to treaty override".

19) Hybrid Entities

Hybrid entities are the result of difference in classification of an entity by two countries in a cross-border scenario i.e. an entity may be classified as fiscally "transparent" in one country but "non-transparent" in another. In general, an entity is fiscally transparent in a country if the entity's current year profits are currently taxable to the owners of the entity, regardless of whether the entity made any distributions to its owners during that year, whereas a non-transparent entity is itself a taxable entity, which is directly assessed for its income.

For example, India considers partnership firms as a taxable entity. It directly taxes partnerships on their income and, in turn, exempts the share of profits received by the partners. However, in some countries, like U.K., taxation of a firm is transparent i.e. it does not tax the income of the firm in the hands of the firm but it taxes the partners individually on income earned through the firm. Hence, in this case, partnership firms would be regarded as fiscally 'transparent' in U.K. and 'non-transparent'/'opaque' in India.

There are also several other entities like limited liability partnerships, trust, partnership, co-operative societies, venture capital funds, collective investment vehicles, etc., taxation of which may differ in different countries.

Such hybrid entities give rise to complications in application of the treaty provisions such as determining the tax-residential status of the entity, calculation of tax credit in case of double taxation, etc. Indeed, a question on the availability of the treaty benefits under the Indo-UK treaty to a partnership firm in U.K. had arisen in the case of **Linklaters LLP vs. ITO [2010] 40 SOT 51 (Mum Trib).** In that case, the assessee was a UK based partnership firm engaged in the practice of law. During the relevant previous year, the assessee rendered services to certain clients whose operations extended to India, and those services were in connection with projects in India. The assessee claimed the income from such services to be not taxable by relying on the Indo-UK DTAA, which provides that business profits cannot be taxed in India in absence of a PE in India. On appeal, a preliminary issue was raised before the Tribunal as to whether the assessee, being a fiscally transparent entity in U.K., was at all eligible to claim any benefit under the Treaty. After considering various international case laws, OECD's report on 'The application of OECD Model Convention to Partnerships - 1999', and India's observation on the same, the Hon'ble Tribunal held that such partnerships though fiscally transparent in UK (the home country), would be eligible to claim treaty benefits under the Indo-UK Treaty, as long as entire profits of the partnership firm were taxed in UK - whether in the hands of the partnership firm or in the hands of the partners directly.

Thereafter, Article 4 of the Indo-UK DTAA on Fiscal Domicile was amended to provided that in case of income derived or paid by a partnership, estate, or trust, the term 'resident of a Contracting State' 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."

BEPS Action 2 has also made recommendations for neutralizing the effect of Hybrid Mismatch Arrangements through amendments in domestic laws and treaties. The recommendations on treaty issues have been implemented under Part II of MLI covering provisions related to transparent entities (Article 3), Dual Resident Entities (Article 4) and Application of Methods for Elimination of Double Taxation.

20) Controlled Foreign Corporation

A Controlled Foreign Corporation ("CFC") is a legal entity that exists in one jurisdiction but is owned or controlled primarily by taxpayers of a different jurisdiction. CFCs are increasingly used as a conduit for outbound investments since a CFC in a low-tax or no-tax jurisdiction achieves "tax deferral" for the owners. In such cases, the income earned by the CFC is subject to minimum tax in the source country and the owners are also not subject to any tax in their home country, till dividend is distributed by the CFC. This is considered as a form of tax-evasion that results in erosion of tax base in the home country.

To curb such practices, various countries have their own CFC laws, which seek to limit such artificial deferral of tax by using offshore low-taxed entities. Countries with CFC rules include, for example, the United States (since 1962), the United Kingdom, Germany, etc. A common feature of these rules, is that they result in a contracting state taxing its residents on income attributable to their participation in certain foreign entities.

Cases may arise where the owners of CFCs are taxed on the income from CFC in their source country and the CFC itself is also taxed on its income in the source country. Such cases may lead to double taxation of same income in two hands in two separate countries, which may appear to be against the spirit of double taxation treaties.

However, a reference may be made Para 3 of Article 1 of OECD MC on 'persons covered' under the tax convention which provides that "*This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under……*". Thus, the provisions confirm that CFC legislations do not conflict with tax conventions. The Commentary on Article 1 further clarifies that the same conclusion must also be reached in the absence of this paragraph in the conventions for the reasons explained in paragraphs 14 of the Commentary on Article 7(1) and 37 of the Commentary on Article 10(5).

For brevity, we are making reference to only Para 37 of the Commentary on Article 10(5) which reads as under:

> "*As confirmed by paragraph 3 of Article 1, paragraph 5 cannot be interpreted as preventing the State of residence of a taxpayer from taxing that taxpayer, pursuant to its controlled foreign companies legislation or other rules with similar effect, on profits which have not been distributed by a foreign company. Moreover, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.*"

Accordingly, it may appear that CFC Regulations are not contradictory to the double taxation treaties.

In India, the concept of CFC was first introduced as part of the proposed Direct Tax Code 2010 ("DTC"), by taxing the undistributed profits of foreign corporation in India, if such foreign corporations were covered within the definition of CFC as provided in DTC. However, DTC never became a law in India and thus, at present we do not have any statutory provisions governing CFC. Instead of CFC Rules, India has implemented 'Place of effective management' (famously known as POEM) whereby a foreign company having POEM in India is treated as a resident in India. POEM means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made. CBDT has issued detailed guidelines to determine whether a foreign company has a POEM in India

Designing of effective CFC Rules is also a recommendation under BEPS Action 3.

21) Mutual Agreement Procedure

Mutual Agreement Procedure ("MAP") is a dispute resolution mechanism provided in the tax treaties to avoid situations of economic double taxation and interpretations of the treaties, which contradict the very purpose of the conventions. Thus, it is a remedy available to the resident of a country (parallel to the normal domestic remedies) to settle the cross border taxation disputes out of the court. The Commentary on OECD-MC and UN-MC explain MAP as under:

> "*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 amicable basis.*"

Generally, any resident of a contracting state can make such an application for MAP to the competent authority of the said contracting state within the specified time limit. In the process of executing a MAP, the competent tax authorities of both the countries interact with each other to arrive at an amicable solution, which suits the intention of the treaty.

In recent years, India has increased its focus on MAP which has resulted in resolution of large number of disputes relating to double taxation. Few initiatives are mentioned below –

- Since April 1, 2014 till February 16, 2016, the CBDT resolved disputes of ₹5,000 crores over 180 cases under MAP.
- In January, 2015 CBDT signed a Framework Agreement with USA under MAP to resolve more than 200 past transfer pricing disputes on Information Technology (Software Development) Services (ITS) and IT enables Services (ITeS).
- On December 9, 2015, India signed an MOU with Korea for suspension of collection of tax during pendency of MAP. Similar MOU has also been signed between India and Sweden in January, 2017.
- During a bilateral meeting between USA and India in the last week of October, 2016, it was agreed to resolve more than 100 cases pending for a long time. These case related to Assessment Years ranging from AY 1999-00 to AY 2011-12.
- In last week of November, 2017, CBDT issued a Press Release stating that it has been decided to accept Transfer Pricing MAP and Advance Pricing Agreement (APA) applications regardless of the presence or otherwise of relevant provisions in the DTAA

BEPS Action 14 on Making Dispute Resolution Mechanisms More Effective contains a commitment by the jurisdictions engaged in the work to implement a minimum standard for improving dispute resolutions. Part V of the MLI provides ways to incorporate these provisions into the CTA.

In line with India's commitment to meet the minimum standard for providing MAP access in transfer pricing cases, specific amendments have been made to several DTAAs which include Singapore, Korea, Kazakhstan, etc.

India is moving towards creating a combination of a robust APA programme and a streamlined MAP programme which would be helpful in creating an environment of tax certainty and encourage MNCs to do business in India.

22) And finally...

The list of important concepts in International taxation can go on and on. It is not the intention to cover the entire subject of international taxation in this one chapter. The reader will find several other concepts discussed in separate chapters, like the concept of ‘permanent establishment’ and ‘fixed base’ or the concepts in interpretation of tax treaties, etc. Once a student, always a student. We shall keep on learning new concepts, unlearning or re-learning the old ones in the light of the development of judicial views thereon. Happy learning…

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