

Important Concepts of International Taxation and Principles of Tax Treaty Interpretation

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Abbreviations

BC	-	Business Connection.
DTA	-	Double Tax Avoidance Agreement.
EC	-	Education Cess.
IT Act	-	Income-tax Act, 1961.
Model	-	DTA model (OECD / UN).
OECD	-	Organisation of Economic Co-operation and Development.
PE	-	Permanent Establishment.
S	-	Section.
UN	-	United Nations.
U/s	-	Under Section.
VC	-	Vienna Convention on the Law of Treaties, 1969.

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1. The subject of International taxation includes several topics listed below. "Tax treaty" is one important part of the subject of "International Taxation", although many times both terms are used interchangeably. In this article, I have used them together to make it one seamless subject.
 - A. **Indian Income-tax Act:**
 1. Scope of taxable income (including deemed provisions for Interest, Royalty and Fees for Technical Services) – sections 5 and 9.
 2. Residential status – section 6.
 3. Exemptions – section 10(4), 10(15)(iv), etc.
 4. Transfer Pricing.
 5. Various special sections – sections 44DA, 115A, ... 172, etc.
 6. Chapter XII-A for NRIs.
 7. Agents and Representative assesseees – sections 160 to 164.
 8. TDS – sections 40(a)(i), 195.
 9. Advance Rulings.
 - B. **Double Tax Avoidance Agreement:**
 1. Scope of DTA.
 2. Residential status.
 3. Permanent Establishment.
 4. Various articles – business income, dividend, interest, etc.
 5. Tax credit and Tax exemption.
 6. DTA models, Commentaries and reports – OECD, UN, US.
 7. Protocols.
 8. DTA v/s. Income tax Act – which overrides which, amendments to DTA, and commentary.
 9. Developing countries V/s. Developed countries – the struggle.
 10. Vienna Convention.

C. **International Tax issues (may be a part of DTA or may not be a part of DTA):**

1. Anti-Abuse provisions.
2. Treaty shopping.
3. Advance Pricing Agreements.
4. Thin capitalisation.
5. Controlled Foreign Corporation Rules.
6. Group Taxation.
7. Triangular situations.
8. Mutual Agreement Procedure.
9. Arbitration.
10. E-Commerce.
11. Tax Havens / offshore centres.

D. **Court decisions:**

1. Indian decisions.
2. Foreign country's decisions.

E. **Some specific non-resident tax issues in India:**

1. Business Process Outsourcing activities.
2. Connectivity issues.
3. Broadband services by telephone companies.
4. Software.
5. Shipping - leasing, slot charges.

F. **Other country's tax laws:**

1. Status of an entity - partnership (transparent or non-transparent), LLC, LLP.
2. Different Tax systems.
3. EU directives, U.S. Treasury explanations.

I do not know many of the above topics. Out of the above, I have dealt with some International Tax concepts and DTA principles. I have been specifically requested to deal with the topic at a basic level. For those of who know this topic, may kindly bear with me.

2. **What are the principles of International Taxation?**

- 2.1 There are no principles. There are only conventions. There is a broad understanding which is adopted by majority of the nations. These are referred to as principles. (Therefore there is a Vienna “Convention” on the Law of Treaties – discussed later in the article.)
- 2.2 The subject of International Taxation involves International tax principles, Double Tax Avoidance Agreements, Tax credits for foreign taxes, and Anti-Abuse provisions.
- 2.3 Taxation is a way of collecting revenues by the Government for functioning of a country. A state collects revenue for its functioning, defence, etc.

A country may collect revenue by way of direct tax, indirect tax, or any other method. For a tax haven, registration fee of U.S. \$ 1,000 per company is more than enough for its functioning. It doesn't need tax revenues. Hence for them, income-tax is irrelevant. However, most of the developed countries earn revenue by way of income-tax.

2.4 **Connecting Factors:**

Countries tax persons based on both or one of the connecting factors – residence and source.

Residents are taxed on Global income – i.e. even on incomes which have arisen outside the resident's country. What is the reason or principle behind it? There is no reason. This is the convention.

Some countries tax people on “residence”, but only on income sourced in their country. They follow “territoriality principle”. (e.g. Hong Kong, Singapore, France.)

The other factor is “source”. If the income arises in a country, or has a nexus with the country, then the country taxes the income. “Source” of income is not defined anywhere in the Indian Income-tax Act. The DTAs also do not lay down source rules. However rules are laid down by countries as to what will be considered as income “sourced” in the country. Goods imported in a country do not make the income of the exporter sourced in the importing country. However import of service can make the income sourced in the importing country (e.g. Technical Services). What is the principle? There is no principle. It is the convention. In fact it is a confused compromise.

Countries lay down criteria for source rules in different manners. What is considered as “sourced” in the country, depends on each country’s laws and practices. Use of different words and phrases in different countries, may not have different meanings. And use of same or similar words and phrases, may have different meanings in different countries. For example, a computer server will not be considered as a PE according to the U.K., whereas U.S.A. considers it as a PE. (Is it because most of the servers were historically physically located in the U.S.!)

3. **Interpretation of Double Tax Avoidance Agreement.**

3.1 The interpretation of Double Tax Avoidance Agreement (DTA) requires a different approach compared to the interpretation of domestic income-tax law. Some of the reasons are:

- Domestic law is enacted with the background of domestic circumstances, and understanding of the situation.

An International Agreement like a DTA cannot take into account all the circumstances and background of the countries involved.

- Domestic law has to be specific – at times to the last rule.

A DTA lays down principles.

This difference in approaches can lead to:

- Difference of understanding of the DTA between two countries,
- Difference between interpretation as per DTA and interpretation per domestic law.

Therefore it is important to understand the principles of interpretation of a DTA.

3.2 A DTA is an International agreement. Its interpretation is based on the principles of interpretation of international law (Vienna Convention) as well as interpretations according to the courts. Essentially, these are contracts between two Governments. Affected parties are tax payers of those two countries. Just as Contract Act covers private contracts; Vienna Convention covers Government Contracts. In India , there have been interesting twists to the DTA interpretation.

The interpretation principles under domestic law, cannot be simply applied to international treaties.

While there are principles laid down, these keep changing over time. At times, they get reversed also. Also different countries have different understandings of a situation. Therefore same principles are applied differently in different countries.

- 3.3 A DTA needs to be interpreted based on the principles of interpretation of international treaties.

The principles of interpretation have been laid down by usage, custom and courts over centuries. These have been codified under the Vienna Convention on the law of Treaties (VC). The VC has not been signed by many countries. India also has not signed the VC.

However, it lays down conventions which are already being followed (or supposed to be followed) internationally.

VC is considered to lay down customary international law, and nothing new. It only codifies customary law.

- 3.4 The articles for interpretation under the VC are Articles 31 to 33 (given at the end of the paper).

Article 31(1) states – “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”.

This is a basic principle. It states that treaties should be interpreted by first giving the ordinary meaning to the language. One need not look at the “subjective intent” of the parties involved. (Prof. Vogel’s commentary, Third Edition – Page 37). The purpose of the treaty is sub-ordinate to the ordinary meaning. It is only if the ordinary meaning is ambiguous, or leads to illogical results, that the purpose may be considered. Any treaty has to be interpreted in “good faith”. It is the basic principle of interpretation even under domestic laws of almost all countries. i.e. it should be honoured like a gentleman’s agreement.

The principle is simple to understand, but its practical application is difficult. There are several reasons – ranging from genuine innocent difference of view, to clear intention to disregard the agreement. One of the reasons for difference of interpretation is different understanding of the terms.

Example 1:

Meaning of employment – A consultant is engaged by a foreign company to work in India. The foreign country considers the income as professional income and does not consider it to be taxable in India as there is no fixed base in India.

India considers the consultancy contract as employment – due to the terms of the contract. As the services are exercised in India, the income is considered to be taxable in India.

Both apply the DTA but the understanding of “employment” is different in both countries.

3.5 The differences can arise due to:

- Differences in understanding of the DTA.
- Differences in understanding of the terms as per DTA and the domestic law.
- Differences in interpretation of domestic law itself.
- Change in the OECD and UN domestic law after signing the DTA.
- Change in the commentary and model after signing the DTA.
- Change in the commentary after signing the DTA – without change in the model.

3.6 A classic difference of interpretation under the DTA and the IT Act is the meaning of “may” and “shall”.

Under the Indian principles of interpretation of law, “may” can be construed as “shall”. Thus if the law uses the phrase – “it may be”, it means it “shall be”. (Sidhwa brothers – 188 ITR 98; Siddheshwar Sahakari Sakhar Karkhana – 270 ITR 1.) However this is not the case under the DTA. For example, the article on dividend states that “Dividend paid by a company which is a resident of a Contracting State (India) to a resident of the other Contracting State (Germany) may be taxed in that other state (Germany)”. This means Germany “may” tax dividends, or “may not” tax dividends (as per its law). It does not mean dividends “shall” be taxed in Germany.

Similarly if an Indian company has a Permanent Establishment in U.K., U.K. may tax the income attributable to the PE [article 7(1)]. This only means U.K. may tax or may not tax the income. It doesn’t mean U.K. shall tax the income, and India cannot tax it. India being the country of residence always has the right to tax (discussed later).

There are some Indian decisions which are contrary to this principle. It was held that if an Indian company has a PE outside India, then the income attributable to the PE is not taxable in India. With due respect, I am not in agreement with those decisions. (Laxmi Textiles - 245 ITR 521; S.R.M. Firm - 208 ITR 400).

Under the DTA, if the income has to be taxed in one country only, the phrase used is "shall be taxable only in ... ". e.g. Article 8 on Shipping and Air transport states - "Profits from 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".

This means shipping and aircraft income out of operation in international traffic can be taxed only in the country where effective management is situated.

4. Importance of Model Commentaries:

- 4.1 Two models relied on most frequently for understanding of DTAs are the OECD Model and the UN Model. The OECD and UN Models have commentaries which elaborate on the model.

The OECD Model and its Commentary maybe agreed to by the members of the OECD. Members who have reservations or observations on any of the provisions of the commentaries, express the same. Even non-members have given their views.

The UN Model and its commentary is a commentary by a Group of Experts.

Both these models have played a tremendous role in understanding of the DTAs. Professionals, Revenue departments and Courts refer to it and also sometimes, rely on it. They have a persuasive value.

- 4.2 The objective is to have common interpretation between countries. This is ideal. However reality is different. The OECD and UN Models are only "models". The actual DTAs are different and based on negotiations between the two countries and situations existing in the respective countries.

Therefore the models and commentaries are "not binding". OECD expects that its members having signed the models, should follow it. However, in reality the countries do follow their own rules of interpretation.

- 4.3 Article 32 of the VC states that recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order

Prof. Klaus Vogel's Commentary states that the Model and Commentary are not preparatory work. Hence they cannot strictly be considered for treaty interpretation. Only that material which is used for negotiation, or material / minutes which has been agreed upon by both parties, can be relied on.

On the above grounds, even the Treasury Explanations given by the U.S.A. are not binding. They represent the U.S. views. Hence at the most, they will help in understanding the U.S. interpretation.

Nevertheless, they do provide an excellent material for the understanding of the DTA.

- 4.4 In India, we have different views by the courts. On one hand, we have several decisions which have referred to OECD model and commentary.

Against that, we have the decision in the case of Chettiar (267 ITR 654). The Supreme Court has observed that the language of the DTA (India - Malaysia) is different from the OECD Model. Hence no purpose will be served by referring to the Model Commentary.

There is a vast difference between:

- i) Certain concepts built into the DTA system; and
- ii) Interpretation of individual words and phrases.

While for the interpretation, we might say that a commentary is not binding, for the system, one should follow the commentary. Non-observance can lead to totally unexpected results. The above Supreme Court decision has held that the Indian resident having rubber plantations in Malaysia, is a resident of Malaysia as he had economic relations which were closer with Malaysia. (It should be noted that there was no issue of dual residence here!). The income was therefore taxable in Malaysia and not in India. A credit method to eliminate double tax, is "converted" into an exemption method.

- 4.5 Having discussed the above, it must be said that the model and the commentaries do have a very good reliability value.

5. **Static V/s. Ambulatory interpretation:**

- 5.1 Article 3(2) refers to terms not explained in the DTA. For such terms, reference can be made to domestic law. The domestic law gets revised periodically.

Static interpretation means the DTA should be interpreted with reference to the domestic law existing at the time of signing the DTA.

Ambulatory interpretation means that the interpretation is with reference to the domestic law as it exists when tax has to be paid. This helps in keeping the meaning updated. If the DTA has to be revised, it is difficult as negotiation of a DTA, and that too with many countries is a time consuming affair.

OECD commentary states clearly that the interpretation should be ambulatory.

- 5.2 Similarly the commentary is also revised periodically. Preferably the revised commentary should be referred to.

Several times the amendment is made in the commentary and the model which is clarificatory. Clarification by itself should not mean that there is a change in the meaning.

Inserting words, or absence of words may not mean a major change in the meaning.

Example 2 :

Article 7 provides for business profits taxation. Article 7(3) provides that in computing profits of the PE, all expenses including executive and general administrative expenses will be allowed as deductions.

Many Indian DTAs contain a provision that expenses will be allowed “subject to the limitations of taxation laws of India”.

This has been interpreted by courts that disallowance of expenses is permitted due to the restriction contained in article 7(3). (Ericsson – 224 ITR 203).

However, without the restriction, expenses can be fully allowed.

OECD has published reports on “Attribution of Profits to PE”. These are detailed reports on how should profits be attributed to a PE. The latest report is of December, 2006. Based on the report, it has published draft changes to the OECD Commentary on Article 7 in April, 2007. There are differences in the views as per report on “Attribution of Profits” and the previous OECD commentary. Therefore at present, the changes suggested in the commentary are only on those aspects on which there are “no conflicts with previous commentary” (para 7).

Para 26 of the report states that expenses to be allowed to the PE will be always as per domestic law. The para is reproduced below:

“26. Also, paragraph 3 only determines which expenses should be attributed to the permanent establishment for purposes of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law.”

Thus even without any specific restriction on allowability of expenses, it was always understood that expenses are allowable only as per domestic law. This was always the understanding.

This is an example of how the interpretation of the DTA has to be broadly understood. Basic principles should be understood. Too much technical interpretation may not always lead to correct results.

- 5.3 The OECD comes out with detailed reports on issues which it considers are important or are causing difficulties. The recommendations in these

reports are incorporated in the commentaries. At times for interpretation, these reports need to be referred to.

6. **Nature of a DTA:**

6.1 A DTA is an agreement between two countries. The tax payer is not a party to it. The DTA is based on negotiations between two countries. Each DTA has to be looked at independently, although there is a lot of common language in the DTAs.

The function of a DTA is of course to eliminate (or reduce) double taxation. However apart from the above, the DTA also distributes rights of taxation between the two countries. It also helps in curbing abuse, exchange of information and limited dispute resolution.

Double taxation occurs due to various reasons. Two basic kinds of double taxation are economic double taxation and juridical double taxation.

Economic double taxation means the same income is taxed twice in two persons' hands, e.g. Corporate profit is taxed and then dividend is also taxed. (Prof. Klaus Vogel's Commentary considers this as a different kind of problem). Or a firm is taxed, and subsequently the partners' share may also be taxed.

Economic double taxation is not eliminated by a DTA.

Juridical double taxation means an income is taxed in one person's hands - but in two different jurisdictions (countries). The two connecting factors (residence and source) lead to taxation of same income in same person's hands by two jurisdictions - Country of Residence as well as Country of Source.

A DTA seeks to eliminate juridical double taxation.

Double taxation may also occur due to the fact that a person may be a resident of both countries. A DTA allocates residence to one country with tie-breaking rules (discussed later).

Double taxation may also occur due to the fact that source is in both countries (and the person is a non-resident of both countries). The DTA does not eliminate this kind of double taxation.

6.2 **Taxing rights:**

A DTA is not a taxing statute. In other words, a DTA does not create a tax liability on its own.

The taxation is governed by the domestic law. If there is no tax as per domestic law, a DTA cannot create it.

Example 3:

Interest earned by an NRI in his NRE account, is taxable in India as per a DTA. However, it is exempt u/s. 10(4)(ii) of IT Act. A DTA cannot create a liability for the NRI, if the Income-tax Act does not create it.

A DTA can only restrict a tax liability.

There are some countries which levy income-tax, based on a DTA, even if there is no tax leviable as per their domestic law. It is based on the logic that a DTA becomes a part of domestic law. Therefore tax can be levied. In my view, this is incorrect. The taxing rights come from domestic law, and not the DTA.

6.3 Does DTA override Income-tax Act?

This is an interesting concept and an important one.

In India, it is accepted that a DTA or Income-tax Act, whichever is more beneficial, applies. This principle is stated in:

- Section 90(2) of Income-tax Act, 1961,
- CBDT circular No. 333 dated 2.4.1982, and
- Various case laws.

Thus for example, the DTA between India and U.S.A. provides for a tax of 15% on Royalty. The rate u/s. 115A is 10%. In such a case, the rate as per Income-tax Act shall apply.

Interest is taxable @ 15% as per the DTA. As per Income-tax Act, the rate is 20% u/s. 115A. In this case, the rate as per the DTA will apply.

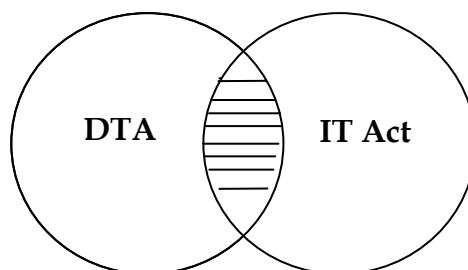
Thus we have best of both the worlds.

This situation however does not prevail in all countries. In U.S.A a DTA becomes a part of domestic law. Hence any subsequent amendment in the domestic law, can override the DTA. Normally, this is not considered appropriate under the International Treaty Conventions.

Thus in India, a non-resident is taxable only if:

- The income is taxable in India as per the DTA, and
- The income is taxable as per the Income-tax Act.

If any one exempts the income, there cannot be any tax. To illustrate by way of a chart, if the income falls in the common area (shaded area), it can be taxed.



This operation of DTA and IT Act that “income is taxable if it is taxable under both - DTA and IT Act”, leads to the observation that “DTA or IT Act whichever is more beneficial applies”.

This application of a DTA is important.

6.4 Which taxes are covered by a DTA?

6.4.1 A DTA covers all direct taxes - on income and capital. Taxes could be levied by any authority - Central Government, State government, local authority, or any political division. Different countries levy income-tax in different manners. Hence the DTA has a wide coverage.

The DTA provides that it shall also apply to identical or substantially similar taxes that are imposed after the signing of the DTA. This is because, the law may be updated, modified or replaced by new law.

Some DTAs list down the specific Acts to which the DTA will apply. The name of the law is not relevant. It is the nature of levy which is important.

India - U.S. DTA refers to excise tax imposed on insurance premium paid to foreign insurance company.

In case of U.S.A., the DTAs apply only to Federal taxes. It does not apply to state taxes. Therefore credit for state taxes cannot be claimed as per the DTA.

What is not covered is social security tax. OECD commentary provides in paragraph 3 of the Commentary on article 2 -

"Social security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as "taxes on the total amount of wages".

- 6.4.2 Under the Indian context, the Income-tax includes Income-tax charged as per Finance Act, surcharge and education cess (EC). I understand that the tax department does not consider education cess for the purpose of taxes covered. This issue is relevant in case of non-resident earning income in India on account of dividend, interest, royalty and fees for technical services. Can education cess be levied over and above the rate prescribed in the DTA?

OECD commentary - paragraph 2 on article 2 - provides as under:

"The method of levying the taxes is equally immaterial: by direct assessment or by deduction at the source, in the form of surtaxes or surcharges, or as additional taxes (centimes additionnels), etc."

Even clause 2(11) of the Finance Act provides that the amount of income-tax shall be further increased by additional surcharge i.e. (education cess)

Therefore in my view, education cess is an additional income-tax. It should be considered as a part of income-tax.

Thus if the DTA limits the tax on interest at 10%, then India cannot levy income-tax (including surcharge and education cess) exceeding 10%. The same logic will apply for Secondary and Higher Education Cess introduced by Finance Act 2007.

Similarly, this is also relevant for claiming credit for foreign tax by Indian residents.

Illustration 1:

	EC is covered by DTA	EC is not covered by DTA
Tax in India - %	20.0	20.0
Education Cess - 2%	0.4	-
Total	20.4	20.0
Less: Foreign Tax	15.0	15.0
Balance Payable in India	5.4	5.0
Add: Education Cess	-	0.1
Net Tax Payable	5.4	5.1

In the above situation, if education cess is not considered as a part of income-tax, it works out to be beneficial.

In my view, education cess is to be considered as a part of total income-tax covered by the DTA.

Can the department argue that education cess is on the Income-tax as per IT Act (i.e. on 20% above), and not give credit for foreign tax against 0.4% of EC? i.e. If foreign tax exceeds 20%, it will be credited against Indian Income-tax of 20%, but not against 0.4% of EC. This means 0.4% tax will be payable.

6.4.3 Is Minimum Alternative Tax and Dividend Distribution Tax covered by DTA? The Groups may debate this issue.

6.5 Treaty Override:

When the domestic law is amended to override the DTA, it is known as treaty override. This is different from the issue discussed in paragraph 6.3 i.e. whether DTA overrides the IT Act.

Is treaty override permissible? This is where “good faith” principle comes into picture. Article 31 of VC provides that treaties should be interpreted in “good faith”. A country cannot amend its domestic law to overcome treaty obligation. Hence the clear answer is, treaty override is not permissible.

If any country overrides an international treaty, then the other country has the power to suspend the treaty or revoke the same.

However does it mean that treaty override can never take place? It can take place for example if there is an abuse of treaty.

6.6 Treaty Abuse:

Treaty abuse means a treaty is used by people for whom it is not meant; or for purposes for which it is not meant. Abuse of treaty is also known as “treaty-shopping”. For example if a company in U.K., invests in India through a Mauritian company to take advantage of India-Mauritius DTA, it can be considered as abuse of treaty. The Authority for Advance Ruling in the case of Natwest (220 ITR 377) had declined to give the ruling (for slightly different legal reason).

The issue is of “substance over form”.

The DTA may have provisions to prevent treaty abuse. For example Dividends, Interest, Royalty and Fees for Technical Services may be taxed at lower rates only if the recipient is the “beneficial owner”.

However if the treaty does not have anti abuse provision can the domestic anti-abuse provision apply? Each country has its own way of looking at this issue. In India too, the judicial view has been both ways. The last major decision has been in the case of Azadi Bachao Andolan. The Supreme Court has stated that if the DTA does not have “limitation of benefits” clause, it cannot be read into it. There is nothing illegal if a resident of a third country takes advantage of India - Mauritius DTA (resorts to treaty shopping).

7. How does a DTA operate?

7.1 Typically a DTA is divided into following parts: (OECD Model Article numbers.)

- I. Application rules - To whom does DTA apply, Taxes covered. (Articles 1, 2, 29)
- II. Definitions. (Articles 3, 4, 5, 10.3, 11.3, 12.2)
- III. The distribution rules - Business profits, Dividends, Employment Income. (Articles 6 to 8, 10 to 22, 28)
- IV. Elimination of Double Tax rules - Credit Method, Exemption method. (Article 23)
- V. Anti-abuse provisions - Transfer pricing, Limitation of benefits article, Exchange of information. (Provisions are also spread over distribution rules.) (Articles 9, 26, 27, 10.2.a, 11.2, 12.1. There is no article on Limitation of benefits under the OECD model.)
- VI. Dispute resolution - Mutual Agreement procedure. (Article 24)
- VII. Special articles - Non-discrimination. (Article 24)
- VIII. Miscellaneous - Entry in force, Termination. (Articles 30, 31)

DTAs may not have all of the above.

7.2 The domestic law continues to apply to the taxation of persons.

A DTA does not create a taxing right. **It only restricts the taxation rights of a country** (normally the source country). The rights are restricted partially or fully. For example:

- The India-Mauritius DTA fully restricts the rights of India to tax capital gains of a non-resident. (Full restriction).
- A DTA usually restricts the rights of taxation of the source country in case of business profits – unless there is a Permanent Establishment in the source country. (Conditional restriction).
- In case of Dividend, Interest, Royalty and Fees for Technical Services, the source country is given rights to tax upto a certain extent (partial restriction).
- In case of immovable property in the source country, the source country always has the right to tax. (No restriction).

Therefore the agreement is also known as distribution agreement. (Distribution by restriction).

7.3 The country of residence always has the right to tax. This is not specifically mentioned. However, as mentioned above, both countries' domestic law continues to govern the taxation. A DTA only restricts taxing rights of the source country. Thus country of residence always has the right to tax.

However, the country of residence has the responsibility to eliminate double tax. The double taxation is eliminated either by giving credit for source country tax, or by exempting the income. This is the only restriction on the country of residence. (In India – Switzerland DTA, for capital gain earned by Swiss resident on sale of Indian company's shares (under certain conditions), India is required to give credit for tax paid in Switzerland. It is a rare example of source country giving credit.)

India has signed DTAs with provisions for tax credits and not tax exemption. (An old DTA with Greece has an exemption method. In case of Brazil DTA also, India has to exempt dividends from Brazilian company if they are taxed in Brazil. These are exceptions.)

7.4 Computation of Income:

A DTA does not lay down computation provisions. It does not lay down the manner in which tax can be collected - Advance Tax, withholding tax, etc. That is left to the domestic law.

Example 4:

Royalty is taxed in Germany at 21%. As per India-Germany DTA, the tax on Royalty is 10%.

A German company initially withholds tax @ 21%. An application is then made to the German tax office. After the approval of application, the balance 11% can be refunded. The approval takes between 3 and 6 months. The lower rate of tax does not apply automatically. This is permissible as per the DTA.

Strictly, the DTA does not even lay down the rate of tax. The tax prescribed for Dividends, Interest and Royalty is only a limitation on gross amount of tax.

Illustration 2:

	Rs.
A non-resident earns interest - from an Indian resident.	1,000
Less: Expenses, interest paid.	<u>700</u>
Net Income	<u>300</u>
Tax @ 30%	90
Tax permitted as per DTA - say 10%.	

Can India levy tax @ 30% when the rate as per DTA is 10%?

The answer is yes - as long as the total amount of tax on gross interest doesn't exceed 10% (i.e. Rs. 100).

8. To whom does a treaty apply?

8.1 Article 1 provides that a treaty applies to a person who is a resident of one or both the states.

Therefore to claim relief under a DTA, two conditions should be fulfilled.

- (i) the claimant should be a person as per the tax laws.
- (ii) A person should be a resident of one or both the countries.

8.2 **Person:**

A person has been defined in article 3(1)(a) of the OECD and UN Model. It provides that “the term “person” includes an individual, a company and any other body of persons”.

Some DTAs specifically provide that a person should be a taxable person.

However, there are persons like a firm – which may or may not be considered as taxable persons.

Partnership firms and entities like trusts, Association of persons create issues. For example, for a firm there can be different situations as under:

A firm may be considered as a person as per commercial law. However, it may not be considered as a person as per tax laws. The partners are directly taxed. (Transparent firm). In some situations, a firm may be treated as a person as per tax law. However partners are taxed, and not the firm.

In some countries like India, a firm is taxed and partners are not taxed (non-transparent firm).

In situations where firm is taxed, remuneration or interest drawn by the partners may be considered as share of profits. In some cases, they could be considered as remuneration or interest.

Different situations in different countries create problems. If a firm is taxable in one country, and partners are taxable in the other, then tax paid by the firm may not be available as a credit to the partners. This causes double taxation.

OECD has come out with a report and has suggested ways in the commentary to eliminate this kind of double tax.

8.3 **Resident:**

8.3.1 A person has to be a resident of one or both countries to avail of DTA relief.

If a person is not a resident of any country, he / it is not entitled to a DTA relief.

Example 5:

A person is considered as a resident of Singapore if he stays in Singapore for 182 days or more in a calendar year.

In India, the residential status is for a financial year.

A person was employed in Singapore with a multinational company. He was a resident of Singapore upto 2006. He had visited India for very short visits during 2006. From 1st January, 2007 he has been deputed to work in the Indian group company. From 1st January, 2007, he does not go back to Singapore. What is implication on residence?

Under Singapore tax law, he is a non-resident of Singapore for calendar year 2007.

Under the Indian Income-tax act, he is a non-resident for F.Y. 2006-07.

Thus for a period of 1st January, 2007 to 31st March, 2007, he is a non-resident of both countries. For this period, he cannot get the benefit of India-Singapore DTA.

Taking the example forward, assume that the person's family continues to stay in Singapore for completion of children's education. The family has stayed till May, 2007. The Singapore company continues to pay him salary from January, 2007. Tax has been paid in Singapore. As the salary is paid for services rendered in India, the Singapore salary is liable to tax even in India.

Will he get credit for tax paid in Singapore, against the tax paid in India? The groups may debate on this issue.

Is a Permanent Establishment entitled to a DTA relief? The Groups may debate on this issue.

- 8.3.2 A person is considered as a resident for the purpose of DTA, if the person is a resident as per article 4.

Article 4(1) 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 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. 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."

Article 4 refers to the residential status of a person according to the domestic law. The person should be "liable to tax" under the laws of that state. The DTA per se does not determine the residence. Residence is only determined by the domestic law.

- 8.3.3 To qualify as a resident, a person should be "liable to tax" in the country of residence.

What is the meaning of a person being "liable to tax"?

Does it mean he should be paying taxes in the country? What if the person is taxable, but his income is exempt?

What if the person is taxable, but due to losses, he is not paying taxes?

Does it include "potential" tax liability?

If a non-resident of India is taxable due to source of income in India, does he become an Indian resident?

This issue has been a matter of debate in the Indian Courts and Authority for Advance Ruling. To discuss the entire issue will require another paper. Here a gist of issues and court decisions has been given.

- 8.3.4 The Advance Ruling in case of M. A. Rafik (213 ITR 317) was among the first rulings which started the debate in India on this concept. It held that Mr. Rafik had paid tax in India, and therefore he was a resident of India as per India-UAE DTA. As he was also a resident of UAE, he was a person having dual residence. Therefore tie-breaking rules were used to determine the residence. In my humble submission, the view is not correct.

A person cannot be considered as a resident, just because he pays taxes. Otherwise all non-resident assesseees will be considered as residents.

As it has been explained earlier, a DTA does not lay down residential status. It has to be determined as per domestic law.

- 8.3.5 "Liable to tax" has to be read with the subsequent words "by reason of domicile,".

Thus a person is a resident and therefore “liable to tax”. OECD refers to “full tax liability” based on a person’s personal attachment to the country.

However, liability does not mean a person should actually pay the tax. If the income is not liable to tax on account of exemptions (e.g. export benefits), losses, etc. a person will still be considered to be “liable to tax”. This means all persons in India who have only agricultural income will be entitled to a DTA as they will be considered as residents of India.

8.3.6 The Advance Ruling in the case of TVM Ltd. (237 ITR 230) observed that a company in Mauritius, will be entitled to the India-Mauritian DTA, if it has paid tax in Mauritius. Otherwise it will not be entitled to the relief.

8.3.7 In Cyril Pereira’s Advance Ruling (239 ITR 650), the Authority elaborated on the issue of “liable to tax” in the matter of India-UAE DTA. The Authority held that there was no Income-tax Act in Dubai applicable to individuals. Only certain kinds of companies were paying taxes. Therefore as there was no double tax, there was no question of application of DTA.

This principle has been followed in Abdul Razak Meman’s Advance Ruling (276 ITR 306) (although the decision is slightly different).

8.3.8 Thus a person should be “liable to tax”, although he may not be “subject to tax”.

8.3.9 Against that, there is a Tribunal decision in the case of Green Emirate Shipping and Travels (286 ITR 60). It has held that the India - UAE DTA will apply. Tribunal has accepted the principle of “Potential Liability”.

8.3.10 In Azadi Bachao Andolan’s case (263 ITR 706), the Supreme Court has held that if the Mauritian authority has issued a Tax Residency Certificate, the person is a resident of Mauritius.

Liability to tax is a legal situation. Payment to tax is a fiscal situation. Payment of tax is not relevant.

8.3.11 Therefore in case of countries where it is possible to obtain a Tax residency certificate, or otherwise it can be established that a person is a tax resident, DTA benefit will be available.

However in case of Dubai, which does not have an Income tax Act for individuals, the tax residency cannot be determined. Availability of DTA becomes debatable.

To take care of this situation, the Government has signed a protocol with UAE for amendment of the DTA. It is yet to be notified. The protocol has defined a resident for the purpose of the DTA.

Even the DTA between India and Saudi Arabia has defined the meaning of a resident for the DTA.

Therefore if a person is a resident of a country, DTA benefit should be available.

Still, is the definition in the DTA sufficient? As per article 4, it is necessary that a person should be "liable to tax" on account of domicile, If there is no Income-tax Act, how can a person be "liable to tax"!

Even section 90 of the IT Act also states that India can sign a DTA for avoiding double taxation.

However going by the intention as per the protocol, the DTA with UAE should apply.

8.3.12 Is potential tax relevant?

Azadi Bachao Andolan's case has referred to the commentary by Prof. Klaus Vogel. The commentary on page 28 states that "the treaty prevents not only "current" but also merely "potential" double taxation. However this should be read with the previous observation - "To the extent that an exemption is agreed to, its effect is in principle independent of both whether the other contracting state imposes a tax in the situation to which the exemption applies and of whether that state actually levies tax".

The country of source may exempt the income under its domestic law (e.g. NRE account interest is exempt in India). The country of residence may or may not tax the income. As on today there is no double taxation. However, if India starts taxing the interest at a future date, double tax will be avoided due to the DTA. This possibility of double tax is "potential double tax". Thus a DTA prevents "potential double taxation".

This is different from "potential tax". In case of Cyril Pereira's decision on applicability of UAE-India DTA, the argument was that there could be a potential tax in UAE. Therefore DTA should apply. The Authority has rejected the argument of "potential tax". It has held that if there is tax imposed by UAE in future, then the DTA will apply. Thus "potential double taxation" will be eliminated.

8.3.13 Subject to tax:

In the decision of General Electric Pension Trust (280 ITR 425), the Authority has discussed the issue of “subject to tax”.

This case was with reference to India – U.S. DTA.

General Electrical Pension Trust was tax exempt entity as per the laws of U.S.A. It was registered as an FII in India.

Under article 4(1) of the India-U.S. DTA, a resident of the contracting state means a person who under the laws of that state is “liable to tax”

Article 4(1)(b) refers to partnership, estate and trusts. It provides in such cases, the term “resident” shall apply only to the extent that income is “subject to tax” as the income of a resident

“Subject to tax” has been interpreted to mean payment of actual tax. However here also, the person may be subject to tax. But only due to losses, or tax credits, if there is no tax payable, the person will still be eligible for DTA relief.

8.3.14 Thus to summarise, there could be following situations:

- (i) There is a domestic income-tax law; and a person is a resident as per the domestic law. Whether the person is subject to tax or not is not relevant.

Supreme Court in Azadi Bachao’s case has held that a person is entitled to DTA relief.

- (ii) There is no domestic income-tax law at all. The person cannot be “liable to tax”.

In such a case, Cyril Pereira’s Advance Ruling has stated that the DTA cannot apply.

- (iii) The DTA refers to a situation where the person should be “subject to tax”. If there is no tax payable then the DTA cannot apply. (General Electric Pension Trust).

8.3.15 The OECD and UN Model and some DTAs have a clause in the article (4) for definition of “Resident” as under:

“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.”

A plain reading would mean that if a person is taxable in respect of income arising only in that country, he will not be considered as a resident for the DTA (although he may be a resident as per the domestic income-tax law). Such a meaning will mean that residents of all countries which follow “territoriality” principle (Hong Kong, France), will never be able to become residents for the DTA and will never be able to enjoy the relief.

This is not the intention. OECD commentary states in paragraph 8 of commentary to article 4 that this provision has to be interpreted strictly. Residents of countries following territoriality principle, should get the DTA benefits.

All “non-residents” are liable to tax in the “source country” only on incomes arising from “sources within that state”. This sentence is to prevent non-residents being treated as a resident by a mistaken interpretation as in Rafik’s case.

This situation may cover individuals like diplomatic staff and consular staff. It may also cover foreign-held companies, who are taxable only on **incomes** within the country of incorporation. Foreign incomes are tax exempt. Offshore countries follow this policy to attract foreigners to form companies in their country. Such companies are taxed only on incomes within the offshore countries. These companies may not get the benefit of the DTA.

8.4 **Dual Residence:**

A person can be a resident of both countries. For such situations, a DTA lays down tie-breaking rules in article 4(2) for individuals, and 4(3) for non-individuals. This determines the country of residence which will have full rights of taxation, and country of source which will have limited rights of taxation.

If due to tie-breaking rules, the residence is allocated to one country, it is referred to a treaty residence of the person.

Can tie-breaking rules apply for part of a year? The answer is yes. Countries have different tax years. U.S.A. has a calendar year as the tax year. U.K. has the year 6th April to 5th April. Tie-breaking rules will apply only to that portion of the year, during which there is a dual residence status.

A person is a resident of India, as well as U.K. As per tie-breaking rules, his residential status is considered to be in U.K.

Will such a person be entitled to benefits available to a non-resident of India? (e.g. interest on NRE accounts - will the same be exempt?). Groups may debate on this issue.

9. Categories of Income:

9.1 Distribution rules determine whether the country has the right to tax the income, and to what extent.

As mentioned above, a DTA only distributes rights of taxation. The manner of taxation is left to the country. Therefore an income may be considered as Royalty under a DTA. When it is actually taxed under the domestic law, it may be taxed as business income.

A DTA categorises the income only for the purpose of considering which country should tax the income and to what extent.

Example 6:

Prior to amendment of definition of Royalty u/s. 9(1)(vi) in 2001, lease of machinery was not considered as Royalty under the Income-tax Act. However a DTA usually considers the lease of machinery as royalty. It allows the country of source to tax the income.

Can we say that the DTA or Income-tax Act, whichever is more beneficial applies?

The answer to the question is 'Yes'. However it is not sufficient. In the example above, the analysis will be as under:

The DTA has granted the taxation rights to the source state (i.e. India).

India can tax the income as per its domestic law - Income-tax Act. How it taxes the income is purely India's look out.

Under the Income-tax Act, the income is not Royalty. However section 9(1)(i) also applies. The income can be considered as accruing in India due to Business Connection. Therefore it will be taxable. The tax on lease income from machinery will be taxed as business income and net profits will be taxable.

9.2 Which articles have preference in the DTA?

The DTA has general articles and specific articles. Needless to say, specific articles have a priority over general articles.

Business profits article is a general article. Articles on Dividend, Interest, Royalty and Fees for Technical services are specific articles. Therefore if income is covered by any of these articles, these will apply and not the Business profits article.

Similarly capital gains article is a specific article.

Article on Shipping and Aircraft income is also more specific. Business profits article does not apply to Shipping and Aircraft income.

Immovable property article is specific to the asset.

In general, the articles related to assets have priority over articles related to income (Prof. Klaus Vogel's commentary - Page 31).

For individuals, Dependent Personal Services article and Independent Personal Services article are general articles.

Article on pension, artist's and sportsman's income is specific. Therefore they have a priority over Dependent Personal Services article.

10. Can the DTA apply in parts? Can one pick and choose?

This issue also has been a matter of debate. There are different circumstances under which this situation can arise.

- (i) The DTA may apply fully for all incomes or it may not apply at all.
- (ii) The DTA may apply for all sources of income under one article. If income falls under different articles, then it may apply for some incomes and not for others.
- (iii) The DTA may apply for each source of income (under one article). For one source, DTA may apply. For another source, the DTA may not apply.

It can be safely said that one can apply a DTA for each category of income. This is clearly brought about by the language of the DTA. Different articles give different taxing rights. Therefore the first view that either the DTA applies fully or not at all, is not correct.

Example 7:

A Mauritian resident has interest income, and Fees for Technical Services (FTS) income from India.

Interest is taxable in India as per the DTA. There is no article on FTS in the DTA. Therefore the income is Business Income. Without a PE in India, it is not taxable in India. (Article 7 of India-Mauritius - DTA).

For interest, one will apply the Indian Income-tax Act. It is not possible to say that if for interest, the Income-tax Act is being applied, for FTS also Income-tax Act should be applied.

The DTA only restricts the application of Income-tax Act. For interest, the DTA permits India to tax, but for FTS, it does not permit India to tax.

The second view is clearly permissible. The DTA can apply for one article and not for another.

The third view is something which may cause some difficulties.

Example 8:

A U.S. company has 3 sources of business income in India.

For Source A, there is a profit of 500

For Source B, there is a loss of 300

For Source C, there is a profit of 1,000

For Source A, it has no PE in India.

For Source B, it has no PE in India.

For Source C, it has a PE in India.

Can the tax payer take a stand that:

- For source A, he will go by the DTA. Therefore as there is no PE, there will be no tax in India;
- For source C, as there is a PE, he will have to offer it for tax; and

- For source B, he will “opt” for Income-tax Act and not the DTA. Therefore loss of 300 will be set off against the income of source C.

The Treasury Explanation on India-U.S. DTA states that such “pick and choose” option is not permitted. The assessee cannot exclude the profits of source A, and also claim the loss of source B.

Such clarifications are not given in case of other DTAs. In my view, the first issue to be considered is – does India have jurisdiction to tax income from source B? The answer is no. If there is no jurisdiction to tax, how can the loss be considered for set off?

It is like allowing loss from agricultural activities against taxable income. We are all aware that if the source of income is exempt, even the loss has to be ignored.

Against that, section 90(2) of IT Act provides that provisions of this act will apply to the extent they are more beneficial. But this is obvious as we have seen. A DTA cannot create a liability, where there is none in the Income-tax Act. However can we apply the DTA if there is a profit, and not apply the DTA if there is a loss?

This is a debatable matter. This is where, the manner in which DTA applies, can help (paragraph 6).

11. Having come upto this stage, it seems that the paper has become long. In order not to tax you further, I have put an end to it, though the debate can continue.

Thank you.

Naresh Ajwani

Vienna Convention on the Law of Treaties
Section 3. Interpretation of Treaties

Article 31
General rule of interpretation

1. 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.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (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 to the treaty.
3. There shall be taken into account, together with the context:
 - (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 in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

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.**

1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.
2. A version of the treaty in a language other than 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.
3. The terms of the treaty are presumed to have the same meaning in each authentic text.
4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.