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Elimination of Double Taxation

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**Naresh Ajwani
Partner
Rashmin Sanghvi & Associates
Chartered Accountants**

Topics Involved

- Scope of Background of Article 23.
- Credit Method / Exemption Method.
- Indian Rules / Some decisions.
- Underlying Tax Credit / Tax Sparing.
- Foreign income of Indian residents – Foreign Tax Credit.

Topics Involved

- Indian income of Non-residents – Taxes Covered under DTA.
- DDT/FBT/Education Cess.
- Timing mismatch – Examples.
- Double Tax – Unrelieved.
- Checklist for Foreign Tax Credit.

Elimination of Double Tax

- Article 23 – The Ultimate Destination!
- It casts a responsibility on Country of Residence (COR) to eliminate double tax.
- Title is misleading. Not just this article, but the whole of the DTA is for elimination of Double tax.

Elimination of Double Tax

- Articles 6-22 – Distributive articles –
 - COS may exempt the income totally – e.g. capital gains as per India – Mauritius DTA.
 - COS may only tax the income. COR cannot tax it. – Shipping/Airline income; Govt. pension.
- Unilateral domestic rules may eliminate double tax.
- If still there is unrelieved double tax, Article 23 comes into picture.

Elimination of Double Tax

- The article applies to countries whose residents earn income in Country of Source (COS).
- Country of Residence (COR) exempts the income from tax, which arises in COS. [Exemption method].
- COR grants a deduction (credit) for tax paid in COS, against tax payable in COR. [Credit Method].

Elimination of Double Tax

- Three kinds of credits are available:
 - Direct tax credit.
 - Underlying tax credit.
 - Tax Sparing.
- The article works in combination with the Distributive Rules of the DTA, domestic tax rules. Non-discrimination article and Mutual Agreement Procedure may also be applicable.

Elimination of Double Tax

- The article may not always eliminate double tax.

Or it may also lead to double non-taxation.

- The manner, procedure, documents & rules for relief are left to the domestic law.

Elimination of Double Tax

- COR is concerned with elimination of double tax. Residents have to suffer double tax.
It is an outbound investment related issue - so to say.
- For all other articles, usually it is a COS issue.
 - Subject to tax.
 - Liable to tax.
 - Beneficial owner.
- Domestic rules can supplement the DTA.

Double Taxation - different kinds

- **Economic double taxation** – same income is taxed twice in two persons' hands.

DTA does not eliminate this double taxation.

- **Juridical double taxation** – income is taxed in one person's hands in two different jurisdictions.

DTA seeks to eliminate this double taxation.

Double Taxation - different kinds

- **Dual residence** – Both countries may seek to tax the person on global income basis.

DTA allocates residence to one country with tie-breaking rules.

- **Dual source** – the income may be considered as sourced in both countries.

DTA does not eliminate this double taxation.

Basic Rule – Credit Method

- **Article 23B(1):**

Where a resident of U.K., derives income which,

in accordance with the provisions of this DTA, may be taxed in India,

U.K. shall allow a deduction from the tax on the income, an amount equal to tax paid in India.

Basic Rule – Credit Method

- **Article 23B(2):**

Where the income derived by a resident of U.K., is exempted from tax in U.K.,

U.K. can take into account the exempted income, to calculate tax on the unexempted income.

Credit Method

- **Full credit** – COR gives credit for the entire tax amount paid in COS.
- **Ordinary credit (proportionate credit)** – COR gives credit for tax paid in COS, which is payable on that portion of income which is taxable in both – COR & COS.

Basic Rule – Exemption Method

- **Article 23A(1):**

Where a resident of U.K., derives income which,

in accordance with the provisions of the DTA may be taxed in India,

U.K. shall, subject to the provisions of paragraphs 2 and 3,

exempt such income from tax.

Basic Rule – Exemption Method

- **Article 23A(2):**

Where a resident of U.K. derives income which,

in accordance with the provisions of articles 10, 11 and 12, may be taxed in India,

U.K. shall allow as a deduction from the tax of that resident an amount equal to the tax paid in India.

Basic Rule – Exemption Method

Such deduction shall not exceed that part of the tax, which is attributable to such items of income derived from India.

Basic Rule – Exemption Method

- **Article 23A(3):**

Where in accordance with any provision of this DTA,

income derived by a resident of a U.K. is exempt from tax in U.K.,

U.K. may calculate tax on the unexempted income.

Basic Rule – Exemption Method

- **Article 23A(4):**

The provisions of paragraph 1 (i.e. U.K. exempts the income) shall not apply to income of a U.K. resident,

where India applies the provision of DTA to exempt such income or applies concessional rate as per article 10(2) or 11.

[OECD Model].

Exemption Method

- **Full exemption** – COR does not consider at all the income taxed in COS. It considers as if the resident never earned that income.
- **Exemption with progression** – COR does not tax the income taxed in COS; but considers that income for determining the tax on the unexempted income.

Credit Method	Exemption Method
Looks at tax.	Looks at income.
Total Tax payable is usually equal to the higher of the rates in two countries.	Tax could be lower than the rate in COR.
The benefit of tax reliefs in COS are enjoyed by COR.	COS can give fiscal benefits which investors can enjoy.
Losses in COS are considered in COR.	Losses in COS ignored.
Investment Export Neutrality.	Investment Import Neutrality.
[See paras 18 to 23 of Model Commentary]	

Indian DTAs – Relief Method

- Normally ordinary credit method is adopted by India.
- In DTAs with Greece (1965 DTA), Bulgaria & Poland, India also has adopted Exemption Method.
- In DTAs with Austria, Belgium, Norway, Poland, Sweden, Switzerland & Turkey, the other country has adopted exemption method.

Foreign Tax Credit – Indian Rules

- There are no rules for FTC.
- Section 91 – applicable where there is no DTA.

Indian residents are given credit for **doubly taxed income**. Lower of foreign tax rate or Indian tax rate is available as credit.

- Section 90 – applicable only when there is a DTA. DTA lays down principles.

Foreign Tax Credit – Indian Rules

- Section 90A – applicable for DTA between specified associations in India & specified territories.
- Very few precedents.
- Chettiar (267 ITR 654)

Malaysian income taxed in Malaysia is exempt from tax in India.

Credit method is converted into Exemption method.

Foreign Tax Credit – Some judicial decisions

- Tax paid abroad has to be considered **country-wise** u/s. 91.

Example

Income Tax

Income & tax in Country A 1,000 300 (30%)

Loss in Country B - 400 -

Net 600 300

Whether credit will be for Rs. 300 or only
Rs. 180 (30% 600)?

(Bombay Burmah Trading – 259 ITR 423).

Foreign Tax Credit – Some judicial decisions

- Credit is available for income which is doubly taxed.

	Income	Tax
Software income in Country A	1,000	200 (20%)

Income in India:

Software income – 10AA	1,000	-
Other income	200	60 (30%)
	<u>1,200</u>	<u>60</u>

Less: Tax Credit - 200 or NIL?

Foreign Tax Credit – Some judicial decisions

(K.V. AL.M. Ramanathan Chettiar – 88 ITR
169). (Dissenting judgement.)

(Mois (M.A.) - 210 ITR 284).

Foreign Tax Credit – Some judicial decisions

- Income to be considered is **ordinary commercial income** for the purpose of foreign tax credit.

(Best & Crompton – 284 ITR 225).

Foreign Tax – Deductible expenditure

- Tax paid to a foreign country cannot be considered as expenditure.

South India Shipping (240 ITR 24).

Kerala Lines (201 ITR 106).

Tax paid is money spent out of profits, & not money spent to earn profits.

S.40(a)(ii) – disallowance of Income-tax applies to foreign taxes also.

Foreign Tax – Deductible expenditure

- Income-tax rate includes surcharge.
(Arthusa Offshore Company – 2008 TIOL – 233 - U.S. companies cannot be charged tax at a rate higher than 15% of domestic tax rate.)
- Dividend from U.K. – whether tax is payable on net basis or gross basis?
(Clive Insurance – 113 ITR 636).
Circular No. 369 dt. 17.9.1983.

Foreign Tax – Deductible expenditure

- Business tax paid in Thailand was allowed as a deduction as it was based on turnover. It was not considered disallowable u/s. 40(a)(ii).
(K.E.C. International – 256 ITR 354).

Foreign Tax – Deductible expenditure

- What is the meaning of income-tax?
Is tax on Gross income income-tax?
Is voluntary payment an income-tax?
Is negotiated tax rate income-tax?
Government may have to come out with guidelines.

Underlying Tax Credit

- UTC means credit for corporate tax.
- UTC operates only when dividends are paid.
If dividends are paid by the company, the shareholder gets credit for:
 - Tax on dividends
 - +
 - Corporate tax on profits out of which dividends are paid.

Underlying Tax Credit

Example:

Corporate profit of Co. A.	1,000
Less: Tax @ 30%	<u>300</u>
Net Profit after tax	700
Dividend declared – say	350
Tax on dividend – say 10%	35

Underlying Tax Credit

Tax in shareholder's COR.	With UTC	Without UTC
Dividend received	350	350
Add: Corporate tax – 50% of 300	150	-
Taxable	500	350
Tax on dividend @ 40%	200	140
Less: Tax credit – Direct.	35	35
- UTC.	150	
Balance tax	15	105

Underlying Tax Credit

- **Without UTC – Cascading effect of taxes:**
An Indian company invests in Mauritius.
Mauritian company invests in U.K. company.
Dividends are declared by U.K. company which flow through to Indian company.

Underlying Tax Credit

Cascading effect of taxes...

Income in U.K.	1,000
Less: Tax in U.K. – 30%.	<u>300</u>
Net profit declared as dividend.	700
Tax on dividend in U.K. – say 20%.	<u>140</u>
Net Funds	560

Underlying Tax Credit

Cascading effect of taxes ...

Net Funds	560
Tax in Mauritius – 15% on 700.	105
Less: Tax credit + UTC.	
(300+120) – Restricted to.	<u>105</u>
Net profit declared as dividend.	560
Less: Tax in India – 30%.	<u>168</u>
Net funds after tax.	<u><u>392</u></u>

Underlying Tax Credit

- **With UTC – Cascading effect reduced:**

Income in Mauritius.	700
Add: UTC – Tax in U.K.	300
Gross income for Mauritius tax.	1,000
Tax in Mauritius @ 15%.	150
Less: Tax credit (300 + 140).	
- Restricted to.	150
Net Funds declared as dividend.	560

Underlying Tax Credit

With UTC.

Net Funds declared as dividend	560	
Add: Tax in Mauritius – UTC.	150	
		710
Tax in India – 30%.	213	
Less: Tax credit – Mauritius UTC.	150	63
Net Funds. (560 – 63)		497

Tax Sparing Credit

- Tax relief in the COS is enjoyed by the Government of resident.
- To avoid transfer of funds from COS to COR, tax sparing is given.

Tax Sparing - Example

Profit from infrastructure activity.	1,000
Less: Relief U/s. 80 -IA.	<u>- 1,000</u>
Tax Profit.	-
Tax saved (or spared). -	300
assuming @ 30%.	

Tax Sparing - Example

	With T.S.	Without T.S.
Profit in home country.	1,000	1,000
Tax @ 40%.	400	400
Less: Tax Sparing Credit.	300	-
Balance tax paid.	<u>100</u>	<u>400</u>

Without tax sparing – 300 saved in India, will be enjoyed by the other country.

Amount of Tax Credit

Singapore income of Indian resident.

Profit before depreciation in Singapore.	10,00,000
Less: Depreciation as per Singapore law.	<u>1,50,000</u>
Profit after depreciation.	8,50,000
Tax @ 20%.	1,70,000
Tax as a percentage of 10,00,000.	17%

Amount of Tax Credit

Total Income of India resident:

Profit in India – Singapore income.	10,00,000
Indian business income.	<u>5,00,000</u>
Total Income	15,00,000
Less: Depreciation as per Indian laws.	<u>3,00,000</u>
Net Profit.	12,00,000
Tax in India @ 30%.	3,60,000
Tax as % of 15,00,000	24%

Amount of Tax Credit

- **Tax Credit – Different possibilities.**

I. Indian Tax.	3,60,000
Less: Singapore Tax.	<u>1,70,000</u>
Net Tax paid in India.	1,90,000
II. Singapore income (10,00,000 – 3,00,000)	7,00,000
Tax in India @ 30%.	2,10,000
Less: Tax in Singapore @ 17%	
on 7,00,000	<u>1,19,000</u>
Net Tax paid in India.	91,000

Amount of Tax Credit

III. Singapore Income before depreciation	10,00,000
Less: Depreciation – proportionate. $3,00,000 \times 10,00,000 / 15,00,000$	2,00,000
Taxable income	8,00,000
Tax in Singapore – 20%.	1,60,000
Net Tax in India. $(3,60,000 - 1,60,000)$	2,00,000

PE Losses

COR follows Exemption Method.		
	Year 1	Year 2
Income in COR	80,000	1,20,000
Loss in India	<u>-20,000</u>	<u>30,000</u>
Total Income.	60,000	1,50,000
Tax in India	Year 1	Year 2
Income / Loss	-20,000	30,000
Less: B/f Loss	-	<u>-20,000</u>
Net Taxable Income.	-	10,000
Tax @ 30%	-	3,000

PE Losses

Tax in COR		
	Year 1	Year 2
I. Total exclusion of Indian income:		
Income	80,000	1,20,000
Tax @ 30% in COR.	24,000	36,000
Tax in India.	-	<u>3,000</u>
Total Tax	24,000	39,000
Total tax in 2 years.		63,000

PE Losses

II. Exclude income; but allow loss [Double Dip]		
	Year 1	Year 2
Income	60,000	1,20,000
Tax @ 30% in COR	18,000	36,000
Tax in India	-	3,000
Total tax	18,000	39,000
Total tax in 2 years.		57,000

PE Losses

III. Restriction on Double Dip:		
Income	60,000	1,20,000
Add: Loss which is set off in India		20,000
	60,000	1,40,000
Tax @ 30% in COR	18,000	42,000
Tax in India	-	3,000
Total tax	18,000	45,000
Total tax in 2 years.		63,000

There is a tax deferral.

PE Losses – Indian situation

- Indian resident earns income from a PE in Japan:

R. M. Muthaiah (202 ITR 508).

SRM Firm (208 ITR 400).

Chettiar (267 ITR 654)

PE income is not taxable in India.

PE Losses – Indian situation

- Patni Computers (109 TTJ 742)
Exclude the foreign income.
Loss is deductible.
Therefore it results in Double Dip.

Pick and Choose

- U.S. Treasury Explanation – India– U.S. DTA.
U.S. company has 3 sources of income in India.

Source	PE Status	Income
A	No PE	5,00
B	No PE	-300
C	PE exists	1,000

Pick and Choose

- Can the assessee elect as under:
For source A, no PE; no tax.
For source B, “opt” for I.T. Act; set off the loss against source C.
- “Pick and choose” not permitted.
Do not set off source B Loss; or offer source A also to tax.

Individual going Abroad

Example:

- Individual is deputed to U.S.A. in Nov. 2007 for two years.

Prior to that he was an Indian resident.

- Nov. 2007 – March, 2008 – Salary is taxable in U.S. & India.
- Jan. '08 – Mar. '08 – How much credit should be claimed?

Individual going Abroad

Final U.S. tax will be known after Dec. '08.
[U.S. has a calendar year.]

In India, return has to be filed by July, '08.

- Practically, file the return on the basis of withholding taxes paid upto March. '08.
- After U.S. assessment is over, file revised return in India.
- May be better to pay less tax in India at the time of filing the original return.

Individual going Abroad

If assessment is over, & refund has to be claimed, it may be lost.

[For old refunds – CBDT instruction No. 13/2006 dt. 22.12.06].

[Hindustan Latex (42 ITD 325) – Principles of natural justice should prevail over technical & procedural issues.]

Individual going Abroad

- U.S. taxes – Will state & city tax be available as credit?

U.S. – India DTA applies only to Federal tax.

Section 91 – credit is available for foreign taxes, only where there is no DTA.

[U.S. residents also do not get credit of foreign tax against state & city tax.]

Individual going Abroad

- Social security tax – Is credit available?
DTA does not apply to social security tax.
[OECD – social security charges means charges paid where there is a direct connection between the levy and individual benefits to be received.]
Can exemption be claimed by claiming –
Diversion by overriding title? – Difficult.
- Is credit available for Flat tax paid in foreign country?

Taxes

- Article 2 – deals with taxes covered by the DTA.
- Nature of tax should be income-tax.
- Income-tax levied in any form by any authority - is eligible for DTA relief.
- In some countries, only Federal Tax is eligible e.g. U.S.A.

Taxes

- FBT/DDT/Surcharge/Education Cess/ R & D Cess/MAT/ Tonnage tax / Agricultural Tax / Municipal Tax/RTO Tax / Interest / Penalty.
- Social security charges not eligible for Tax credit.

Dividend Distribution Tax (DDT)

- Can credit be available for DDT as:
 - Direct Credit.
 - UTC.
- Is DDT tax on income?
- Can we consider that DDT has been paid by earner of income?
- Is it necessary that income earner should pay the tax?

Dividend Distribution Tax (DDT)

- S.115-O – Dividends shall be charged to **additional income-tax**.

S.115-O(2) fixes the liability on the company.
Thus company pays income-tax +DDT.

This is a COR issue.

- Can DDT be considered as a part of UTC?
(Article 24(1)(b) of India – U.K. DTA).

Dividend Distribution Tax (DDT)

- **Article 24(1)(b):** In the case of a dividend paid by a company which is a resident of India to a company which is a resident of the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the company paying the dividend, the **credit shall take into account** (in addition to any Indian tax for which credit may be allowed under the provisions of sub-paragraph (a) of this

Dividend Distribution Tax (DDT)

paragraph) the Indian tax payable by the company in respect of the profits out of which such dividend is paid.

Dividend Distribution Tax (DDT)

- U.K. & Mauritius have clarified that they will give credit for DDT.
- Can DDT be restricted to DTA rate?
India-U.K. DTA- Article 11(2) –
- Can an Advance Ruling be obtained?
S.245N(a)(i) – Does the non-resident bear the tax?
S.245N(a)(ii) – Is it a tax liability of the non-resident?

Fringe Benefits Tax

- Is it a tax covered under the DTA?
- Whose tax is being paid – Employer or Employee?
- Who will get the credit – Employer or Employee?

[Employee may be taxed in his home country. In India, employer will pay FBT.]

Fringe Benefits Tax

- For the employer, can we say, it is tax on income, or is it a tax on expenditure?
[Even if there is a loss, FBT may be payable.]
- FBT may be payable without having a PE. There may be no income taxable in India, yet FBT is paid. Will it be available as credit?
- It is a COR issue.

Education Cess

- Cess means a tax for specific purpose. When levied as increment to an existing tax, the name matters not for the validity of the cess must be judged of in the same way as the validity of the tax to which it is increment.

(Chaturvedi & Pithisaria, fifth edition, Page 2377.)

Education Cess

	E.C. after FTC	E.C. before FTC
Tax in India on Foreign Income	300	300
I. Less: Foreign Tax	- 200	
	100	
Add: Education Cess @ 3%.	3	9
		309
II. Less: Foreign Tax		200
Tax in India	103	109

Education Cess

	E.C. is not a part of I.Tax	E.C. is part of I.Tax
Tax in India on Foreign Income	300	300
Add: Education Cess	<u>9</u>	<u>9</u>
Total Tax	309	309
Foreign Tax – 400		
Restricted to	<u>300</u>	<u>309</u>
Net Tax in India	9	-

Timing Mismatch - Examples

- Emigrants from Australia pay capital gains tax on deemed basis as if assets have been sold on date of emigration. Will they get credit in COR when assets are actually sold?
- U.S.A. – Installment sale.
- Different meanings of accrual.

Timing Mismatch - Examples

- Singapore – DTA applies only to the extent income remitted to Singapore.

[Thoresen Chartering – Mumbai Tribunal – June, '08 – Tax charged at full rates if income is not remitted to Singapore]

In subsequent year, if the income is remitted, will Singapore give credit for excess tax paid in India? Will India give refund?

Documents for Tax Credit

- DTA does not prescribe any documents or procedure. It is left to the domestic law.
- Indian Income-tax Act / Rules also do not prescribe any procedures/documents.
- Following documents help
 - Foreign TDS certificate.
 - Tax payment slips / challans.
 - Foreign tax return.
 - Certificate from foreign C.A.

Double Tax - Unrelieved

- A non-resident of both countries having dual source income may have unrelieved double tax.

Example:

A person normally resident in Singapore, is deputed to India w.e.f. 1.1.08. He gets family allowance from Jan. to Apr. '08 as his family is in Singapore. This allowance is taxed in Singapore. Will he get credit for Singapore tax in India?

Checklist for Foreign Tax Credit

- Identify the **person** – who has earned the income, & who has borne the tax?
- Is the tax covered under the **DTA**?
If yes, credit available as per DTA.
- Are there **domestic FTC rules**?
- Is the DTA FTC limited by domestic FTC rules?

Checklist for Foreign Tax Credit

- How much income can be considered as **foreign income as per ordinary commercial principles?**
- Determine **taxable income earned abroad.**
Expenses attributable to foreign income should be deducted from foreign income.
Apply COR rules for computing foreign income. (Can we apply S. 14A & Rule 8D?)
- Determine tax on doubly taxed income in COR.

Checklist for Foreign Tax Credit

- Finality of tax in COS is generally available for credit.
- Timing mismatches.

[Practically tax credit may be available without strictly going into detailed rules.]

Questions & Comments are welcome.

Naresh Ajwani