Western India Regional Council of ICAI

Why and How of International Tax – Past and the present; Tax treaty framework, its reading and interpretation

CA. Vasudevan G

Date: 26 August 2022

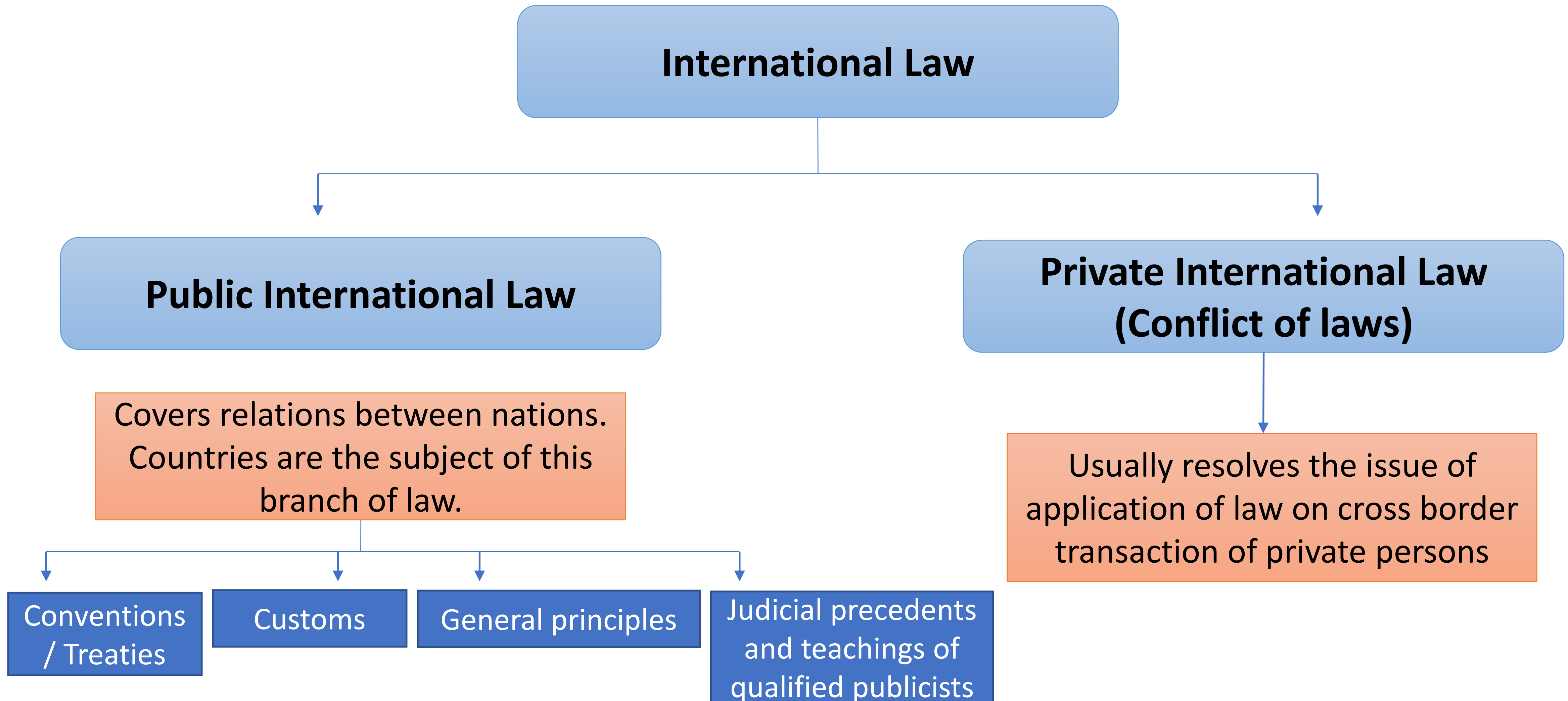
Overview

Globeview

- Background
- History of International Tax – origins of bilateral tax conventions
- Development of International Tax over the years
- Treaty Frameworks – OECD and UN Model Convention
- Interpretation of Tax treaties
- BEPS projects
- Multilateral Instruments (MLI)
- Recent developments in International Tax

Background

Globeview



Background

- Generally accepted that taxation is a sovereign function.

- In India – Constitution provides powers to tax to the Central and State Governments (separate lists).

- In general, extra territorial operation is allowed under the constitution. Article 245 reads as under:

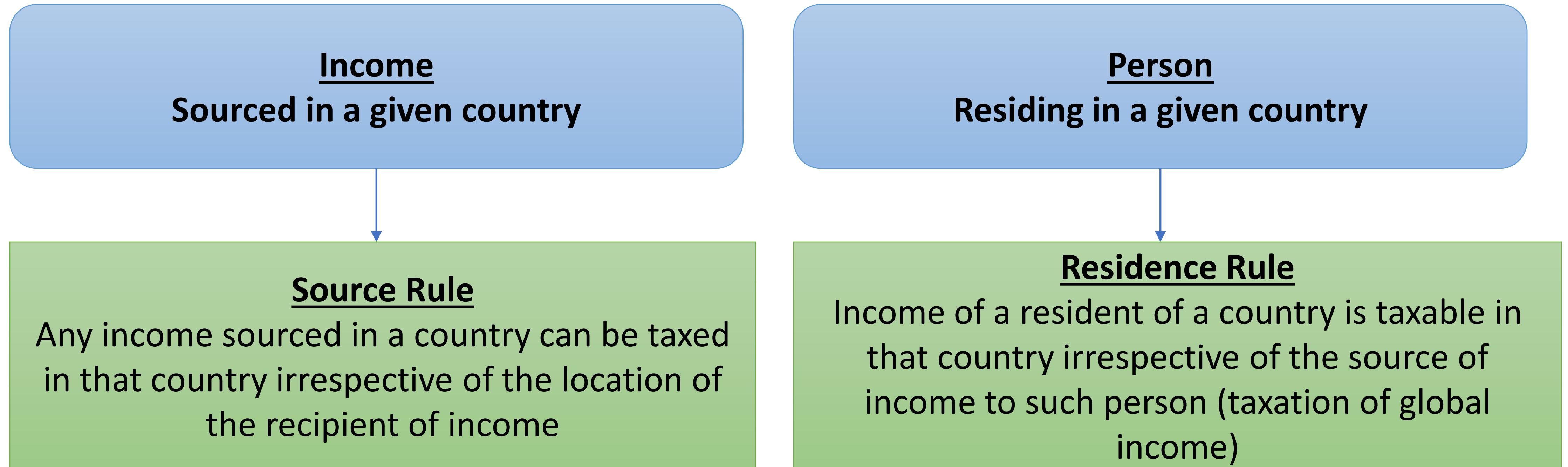
  "Article 245. Extent of laws made by Parliament and by the Legislatures of States.—(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

  (2) No law made by ***Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation****."*

- The extra-territorial operation is not unlimited. It shall have nexus with India or Indians – ***GVK Industries Ltd. v. ITO (2011) 332 ITR 130 (SC)*** (Constitution Bench).

Background

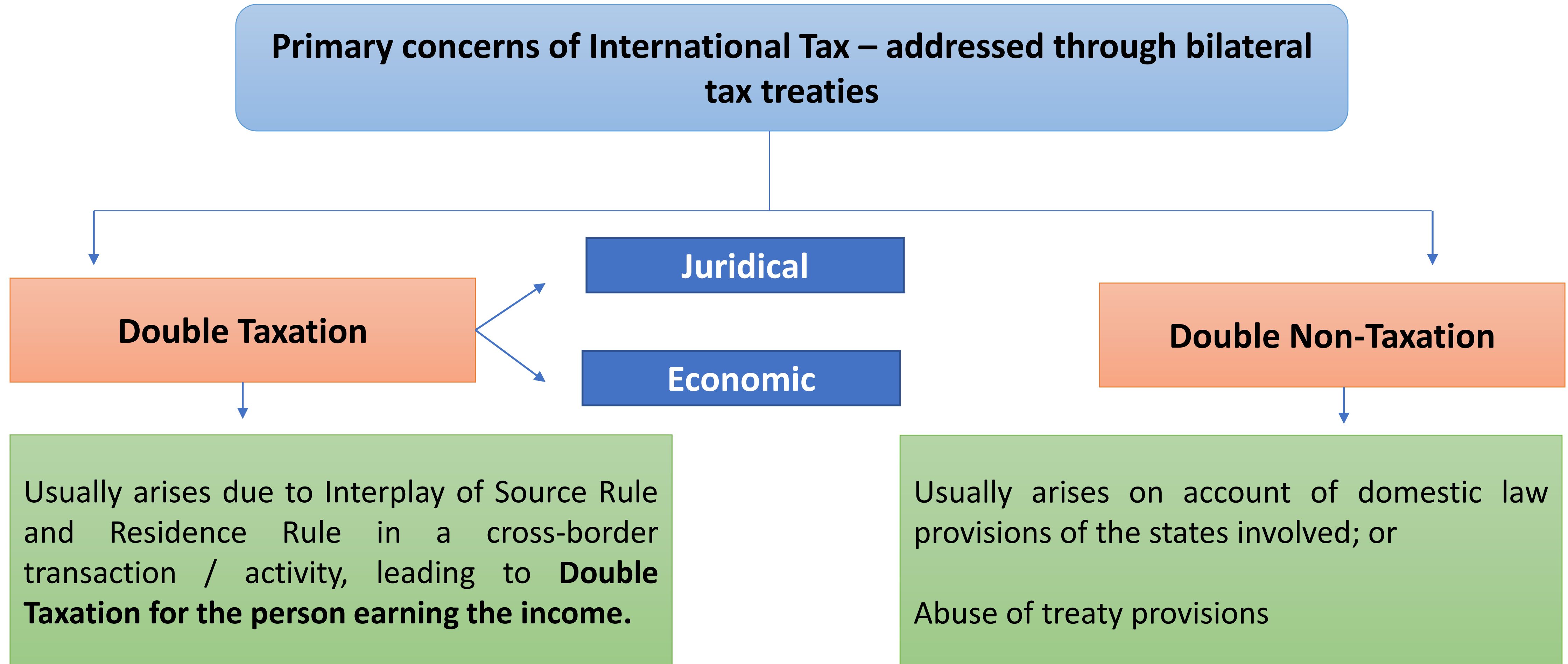
- Aspects of Income Tax having Geographical attributes:



India applies both the above rules simultaneously.
Singapore applies only Source Rule
US taxes Global income of its citizens irrespective of their residential status

Why International Tax?

- Broadly, International Tax deals with the interplay of taxation rights of different countries.



Means of addressing Double Taxation

Globeview

Unilateral Measures –
By unilaterally not imposing tax on income earned in another jurisdiction

Allocation of taxing rights -
Taxing rights for different income can be allocated between jurisdictions

Allowing credit for taxes paid in foreign jurisdiction on the same income

Globeview

History of International tax – Bilateral treaties

- Origins of Bilateral tax conventions – Pre Word War I

Year	Details
1843	Treaty on administrative cooperation between France and Belgium on taxation matters. (**1845** – Belgium – Netherlands and Belgium – Luxembourg)
1899	Treaty for avoidance of double tax between Austro-Hungary and Prussia (contained PE provision, Allocation of rights – country of domicile for personal taxes and country of source for property and business taxes, MAP
1901	DTAA between Austro-Hungary and Liechtenstein
1903 – 1913	DTAA between Austo-Hungary and other German states (Saxony, Bavaria, etc.)
1909 – 1913	DTAA between Luxembourg and German states and Swiss

Source: Prelude to the International Tax Treaty Network: 1815-1914 Early Tax Treaties and the Conditions for Act - Sunita Jogarajan: Oxford Journal of Legal Studies, Vol 31, No. 4 (2011) pp. 679 - 707

Globeview

Development of International Tax – post WW-I

- Post World War – I, **League of Nation** was formed.
- Treaty networks formed in Europe quickly. First – Germany and Italy in 1925.
- In **1927** – Fiscal Committee of the League of Nations prepared first draft Model Convention; adopted in 1928
- In **1946** – This convention was published by Fiscal Committee of UN Social & Economic Council
- In **1963** – Organisation for European Economic Cooperation (OEEC) published the model convention
- Subsequently, OECD (successor of OEEC), approved the draft presented to the OEEC.
- In **1977** – Final draft was prepared by OECD (now called as OECD model) and was revised subsequently multiple times and latest version was released in 2017.
- In **1980** – UN Model Convention was published for the first time (updates in 2001, 2011, 2017)

Tax treaty framework

- OECD Model Tax Convention on **Income and on Capital**
- UN Model Double Tax Convention between **Developed and Developing Countries**
- United States Model Income Tax Convention **– US Model**
- **Andean Model** – Regional level model convention developed on 1971 – limited lesser and medium developed Latin American countries – Bolivia, Columbia, Chile, Ecuador, Peru and Venezuela – provides for almost exclusive tax in source country, except in cases of international traffic. PE concept not incorporated.

Major difference in treaty models

Globeview

Subject	OECD Model	UN Model
Residency	Place of incorporation is not a criteria – only place of management	Place of incorporation would create residency
Construction PE	Narrow definition Prescribed period - 12 months	Broader definition Prescribed period – 6 months
Service PE	No clause to this effect	Presence of person for over 183 days in any 12 month period
Business profits	Only business income attributed to PE may be taxed	Even from country not directly through PE also covered for tax
Royalty	Royalty taxable only in the Resident state	Royalty income may be taxed in the other state as well **(but usually there is a cap on tax rates)**
Independent personal services	Deleted	Taxable in the state of residency – except when physical presence in other country in more than 183 days

Interpretation of tax treaty (1/2)

Globeview

- Tax treaties are not comparable to general legislation in terms of its formation mechanics or the underlying consideration – They involve deep political and economic interest factors

- Treaties are not negotiated by law makers but signed by appointed representatives of each county

- Since treaty is a convention between two countries, hence should be interpreted as per Vienna Convention on Law of treaties, 1981 (**VCLT**)
  - Article 26 - *Every treaty in force is binding upon the parties to it and must be performed by them in good faith*
  - *Article 27 - A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46.*
  - *Article 31*
    - *Ordinary meaning in the light of object and purpose ; subsequent agreements might be referred*
    - *Supplementary means - preparatory work of the treaty may be referred to understand intent*

Interpretation of tax treaty (2/2)

- Customary International Law – treaty interpretation rules
  - *Golden Rule – Objective interpretation* – with objective/literal meaning
  - *Subjective Interpretation*
  - *Purposive interpretation*
  - *Contemporanea Expositio*
  - *Liberal construction*
  - *Integrated approach*
  - *Reasonableness and consistency*

- Commentaries on Model conventions can also be referred.

Power to enter into DTAA and its supremacy

Globeview

- Power to enter DTAA by Government is provided under Section 90(2) of the Act

- Provisions of Treaty shall override Income Tax Act, to the extent beneficial to the Assessee [*UOI v. Azadi Bachao Andolan (2003) 263 ITR 706 (SC)]*

- *Section 90(2) reads - Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies,* ***the provisions of this Act shall apply to the extent they are more beneficial to that assessee.***

- Where a term is not defined in the Treaty, the Income Tax Act definition shall apply.

What is Base Erosion & Profits Shifting (BEPS)?

- OECD states as under:
  - BEPS refers to **tax planning strategies** that **exploit** gaps and mismatches in tax rules to **artificially shift profits to low or no-tax locations** where there is **little or no economic activity** or to erode tax bases through deductible payments such as interest or royalties. Although some of the schemes used are illegal, most are not.
  - This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level.
  - BEPS practices cost countries **USD 100-240 billion** in lost revenue **annually**. Working together within OECD/G20 Inclusive Framework on BEPS, over 135 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.
  - BEPS is of **major significance for developing countries** due to their **heavy reliance on corporate income tax**, particularly from multinational enterprises. Engaging developing countries in the international tax agenda is important to ensure that they receive support to address their specific needs and can effectively participate in the process of standard-setting on international tax.

Measures to tackle BEPS

Globeview

- OECD and G20 leadership in September 2013, came together to devise mechanisms to address weaknesses of the international tax system that create opportunities for BEPS.

- This project allowed participation of countries outside of OECD and G20 memberships to engage in discussion on actions against BEPS – hence called Inclusive Framework (“**IF**”).

- OECD and G20 agreed on BEPS Package – consisting of 15 Actions, including certain minimum standards which mandatorily were to be applied by members of IF.

- In November 2016, the negotiations on Multilateral convention to implement Tax Treaty related measures to prevent BEPS was signed. To date over 99 countries have signed MLI covering over 1800 tax treaties worldwide. Application depends on matching of preferences by parties.

- First MLI entry into Force was on 1st July 2018 with first application starting on 1 January 2019. India deposited Instrument of Ratification on 25 June 2019 with Entry into Force on 01 October 2019.

Globeview

Important BEPS Action Plans

Action Plan	Description	Whether minimum std.?
1	Tax Challenges arising from digitalization	No
4	Limitation on Interest Deductions	No
5	Harmful Tax practices	Yes
6	Prevention of tax treaty abuse	Yes
7	Permanent Establishment Status	No
8 – 10	Transfer Pricing	No
13	Country-by-country reporting	Yes
14	Mutual Agreement Procedure	Yes
15	Multilateral Instruments	Means to implementation of treaty based changes suggested under Action plans

MLI – Some important clauses

Article ref.	Description	India's stance
Art. 4	Mandatory Mutual Agreement between jurisdiction for determination of residential status – tie break scenario	Existing in many DTAAs
Art. 6	To add a preamble – Purpose of CTA – elimination of double taxation **without creating opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance**	Mandatory standard
Art. 7	Principle Purpose Test (**PPT**) – Benefits of the treaty may be denied if **one of the principal purpose** of any arrangement or transaction was to obtain treaty benefits.	Simplified LOB
Art. 12-15	Stricter norms for constituting PE	Existing in many DTAAs
Art. 18 – 26	Mandatory Binding Arbitration – If MAP fails	Position not clarified

Recent Development – BEPS 2.0

- On 8 October 2021 – OECD released a statement that members of OECD/G20 IF have agreed to a Two-Pillar solution to Address the tax challenges Arising from the Digitalisation of the Economy.

- As of 04 November 2021 – 135 countries had joined the measure.

- **Two Pillar Solution** –

Pillar 1

- Reallocation of taxing rights to market jurisdiction based on economic nexus w.r.t digital services and consumer facing businesses regardless of physical presence
- Applies to MNEs with global turnover of €20 Bn.
- Allocable profit – 25% of profit in excess of 10%
- Estimated additional tax revenue - $125 Bn.
- Will do away with **Unilateral DST measures** (?)

Pillar 2

- Embodies global commitment to ensure MNEs pay effective tax of 15% in each jurisdiction where they operate.
- Applicable to MNEs having consolidated global turnover above €750 Mn. p.a.
- Estimated additional tax revenue - $150 Bn.
- Also provides for Subject to Tax rule – minimum tax rate on passive income (~9%)

Globeview

Recent Development – BEPS 2.0

- USTR investigation on India – Equalisation Levy

- India agreed to provide Credit of EL paid from 01 April 2022 against tax that would accrue under Pillar 1

- Proposed change in tax rates in various Asian countries
  - Dubai has introduced corporate tax applicable from June 2023 (9%)
  - Singapore contemplating top-up tax
  - Similarly, Hongkong, Malaysia.

Thank you

vasudevan.g@globeviewadvisors.com