

# **Introduction to Tax Treaties and its application**

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# Overview

- Every nation has a right to tax its residents/nationals on their global income
- As a result, the income of a person “may get taxed” in both the countries i.e. the home country and the host country
- In home country tax is an obligation, while in host country tax is a cost
- Double Tax Avoidance Agreements (*DTAA*) come into play to mitigate hardships caused by taxing the same income twice
- DTAA's are also known as Tax Treaty and Double Tax Conventions (*DTC*)

## What is a Treaty?

- A tax treaty is a form of agreement between two or more national jurisdictions concerning taxes where the main purpose of which is to regulate matters concerning taxes
- The application of the term 'treaty' in the generic sense signifies that the parties intend to create rights and obligation enforceable under international law
- Treaty includes: convention, agreement, arrangement, protocol and exchange of notes, unilateral statements, memorandum of agreement

# Need for Tax Treaties (1/2)

- **Growth in International Transactions**

- Trade

- Reduction in tariff and non-tariff barriers
    - Development of trade blocs

- Labour

- Freedom of cross border work for highly skilled labour
    - Freedom of movement of labour in trade blocs
    - Immigration programs encourage wealthy and skilled migrants

- Technology

- Reduced restrictions on international transfers of technology

- Investment

- Loosening of controls on foreign direct investment
    - Reduced restrictions on portfolio investment across borders

## Need for Tax Treaties (2/2)

- **Globalization of world economy**
  - Growth in international trade, finance and investment surpasses growth in the world economy
  - All laws dealing with international transactions increasing in importance
- **Cross border transaction**
  - Transaction between a resident and a non-resident
  - Transaction between two non-residents having nexus with India
  - Transaction initiated in one state and concluded in another state

# Purpose of tax treaties

- Elimination of double taxation
- Certainty of tax treatment
- Reduce tax rates
- Lower compliance costs
- Prevention of fiscal evasion
- Prevention of tax discrimination
- Resolution for tax disputes

## Formulation of tax treaty

- Negotiation of a tax treaty (by Ministry of Finance – Department of Revenue)
- Drafting of the articles (by Ministry of Finance – Department of Revenue)
- Signing (typically, by the Chairman of CBDT)
- Ratification (by Ministry of Finance – Department of Revenue)
- Notification (by CBDT)

# Basic features of tax treaties

- Bilateral international treaties
- Incorporated into domestic law
- Intended to override domestic law
- Generally follows the structure of the OECD Model
- Variations to take account of national and developing country requirements



# Double Taxation (1/2)

- What is Double Taxation
  - One country claims to tax on the basis of “Source of Income” and another on the basis of “Residence”; or
  - Both countries claim to tax same incomes based on “Residence”
- Relief in India from Double Taxation

## Section 90

- Regulates a case where India has a tax treaty
- Taxpayer has the option to be taxed as per tax treaty or domestic tax laws, whichever is more beneficial [S.90(2)]
- Subject thereto, domestic law has full force
- Domestic law provisions can, at times, be more beneficial
- Circulars issued by the CBDT

## Section 91

- Relief from double taxation if India has no tax treaties
- Person resident in India is allowed credit of foreign taxes paid against amount of Indian taxes

## Double Taxation (2/2)

- Section 90A(4) provides that treaty benefit will not be available to any non-resident unless he furnishes Tax Residency Certificate from Government of other country including therein particulars
- Explanatory Memorandum of Finance Bill 2012 had stated that submission of TRC is 'necessary but not a sufficient condition' for claiming benefits under DTAA. This is now provided in S.90(5) of the Act
- Rule 21AB was further amended vide notification no. 57/2013 dated 1 August 2013. The CBDT also inserted Form No. 10F for providing information under section 90(5) or section 90A(5) of the Act

## Terms employed by Tax Treaties

Term	Meaning
Contracting state	A country which enters into a contract
State of residence	A country wherein a person resides
State of source	A country wherein income arises
Enterprise of a contracting state	Any taxable entity
Permanent establishment	A fixed base of enterprise in the State of source
Income arising in contracting State	Income arising in a State of source

# International consensus on taxation of income

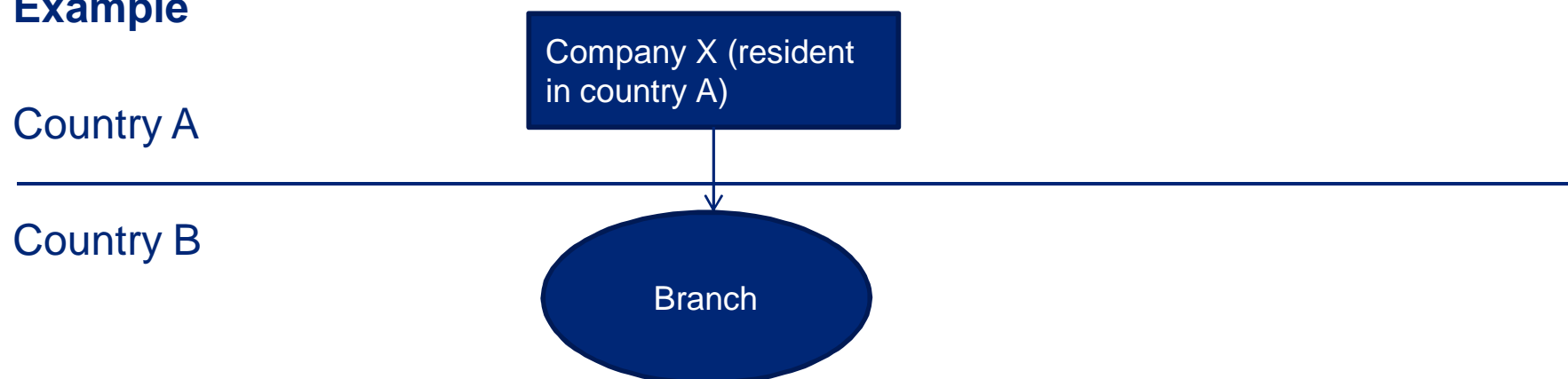
- **Source principle**  
Country of source of income has right to tax
- **Residence principle**  
Country of residence of taxpayer has right to tax on world-wide basis
- **Relationship of source and residence principles**  
Source country has prior right to tax  
Source country right to tax limited especially for passive income  
Residence country has residual right to tax  
Residence country has obligation to relieve double taxation
- **Elimination of double taxation – Juridical v Economic Double Taxation**  
Double Taxation occurs when there is ‘worldwide + source taxation’ or ‘residence in two countries’  
Double taxation is eliminated by allocation of exclusive right to tax to a country or sharing of taxing rights by the countries
- **Consensus expressed in tax treaties between countries based on internationally agreed models**

# Juridical and Economic Double Taxation (1/2)

## Juridical double taxation

- Same legal entity is subject to tax, on same income, in two (or more) countries
- Arises because most countries:
  - tax residents on global income (i.e. regardless of source); and
  - tax non-residents on domestic-source income

## Example



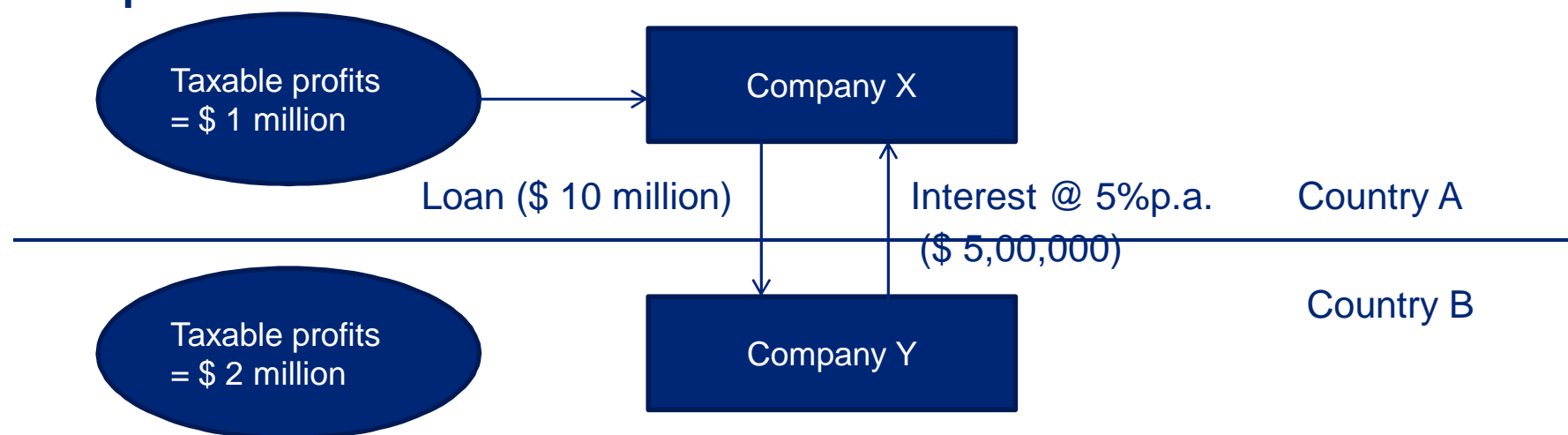
Company X's branch profits are subject to tax in two countries:  
(i) in Country A, due to residence; and  
(ii) in Country B, due to source.

## Juridical and Economic Double Taxation (2/2)

### Economic double taxation

- Two legal entities are subject to tax, on (economically) the same income, in two (or more) countries.
- Generally arises where one country applies its transfer pricing rules.

### Example



- If Country B considers that the arm's length rate of interest on the loan should be 4% p.a., it will reduce Company Y's interest deduction by \$100,000
- Company Y's taxable profits increase by \$ 100,000 to \$ 2.1 million
- Unless Country A provides some relief for Company X, economic double taxation will occur in respect of the \$ 100,000

## Tax Treaty v. Domestic Law

<b>Tax Treaty</b>	<b>Domestic Law</b>
Agreement between two States	Act of Legislation
Involve negotiation process	No negotiation
Relief from double tax	Charge of tax
Sharing of tax revenue	Earning of tax revenue
No frequent changes	Frequent amendments
International law	National law
Dispute settled by appellate forum/court/MAP	Dispute settled by appellate forum/court

# Treaties are agreement between Governments

- Treaties are signed by two national jurisdictions to regulate matters concerning taxes
- Taxpayer is not a party to a tax treaty
- Desire of signatories to make business environment in their jurisdictions tax friendly
- Treaty represents understanding as to rights and obligations of respective country
  - to forego its right to tax,
  - to limit scope or rate of taxation,
  - to grant credit of tax paid directly or indirectly in other jurisdiction/s etc. etc.
- Understanding between Governments is to share tax revenues equitably as between themselves, while mitigating hardship for taxpayers



## Treaties are agreement between Governments

- Treaties can only relieve tax burden
- Treaties do not create any charge
- Klaus Vogel :

*“A tax treaty neither generates a tax claim that does not otherwise exist under domestic law nor expands the scope or alters the type of an existing claim”*

# Types of Tax Treaties (1/2)

## Different types of double tax treaties:

- Limited treaties
  - Deals with specific subject matter
    - DTAA between India and Pakistan is limited to air transport only
    - Exchange of information with British Virgin Islands
- Comprehensive treaties
  - Deals with most sources of income
- Multilateral treaties vs. Bilateral treaties
  - EU Directives
  - SAARC Income Tax Agreement - Bangladesh; Bhutan; India; Maldives; Nepal; Pakistan; Sri Lanka ( sharing of tax policies, training to tax administration, teachers, students taxation, etc. )
  - Multilateral – between three or more countries
  - Bilateral – between two countries

# Types of Tax Treaties (2/2)

## Different models followed:

- **OECD Model**  
The most important document in international tax  
Issued by the CFA of the OECD  
Followed by Developed Nations
- **UN Model**  
Based on OECD model  
Is focused on double tax treaties between developed & developing countries  
Allows greater source country taxation than the OECD model
- **US Model**  
Served as a basis for US treaty negotiations

# Treaty under the OECD Model

- Organization for Economic Co-operation and Development (OECD)
  - Established in 1961 with developed countries as its members
  - Essentially a model treaty between two developed nations with comparable tax systems and tax objectives
  - Advocates residence principle
    - Lays emphasis on the right of state of residence to tax
      - Royalty taxation in the state of residence
      - Excludes taxation on services in the name of service PE
- Currently 34 countries including Australia, US, UK, France, Germany etc. are OECD members
- India not a OECD member
  - Currently has been granted the “Observer” status

## Treaty under the UN Model

- Tax treaties between countries with unequal economic status – Developed and lesser developed countries, or between developing countries
- Drafted in 1980, designed to encourage flow of investments from the developed to developing countries
- Is a compromise between source principle and residence principle
- Gives more weightage to source principle, i.e. income should be taxed where it arises
  - Payer of income is considered as the source of taxation
  - Reduced threshold of construction PE
- Most of India's tax treaties are based on UN Model

## Historical Development (1/3)

- The first treaty between Austria and Hungary was signed on 21 June 1899
- From 1918 onwards, US was aggressive in giving Foreign Tax Credit
- Netherlands and Belgium provided Foreign Tax Credit to their colonies
- International Chamber of Commerce was set up in 1920
- In 1921, the four general principles were adopted at the London Congress
- In 1922, Committee drafted resolution which were revised in 1924

## Historical Development (2/3)

- League of Nations was set up after the first world war
- In 1925, report on Double Taxation and Fiscal Evasion was submitted
- In 1928, First Four Model Conventions for the prevention of Double Taxation were developed
- In 1943, Mexico Model of Tax Convention had emerged
- In 1946, London Model of Convention was drafted
- In 1956, OECD was set up which started working on the DTA model

## Historical Development (3/3)

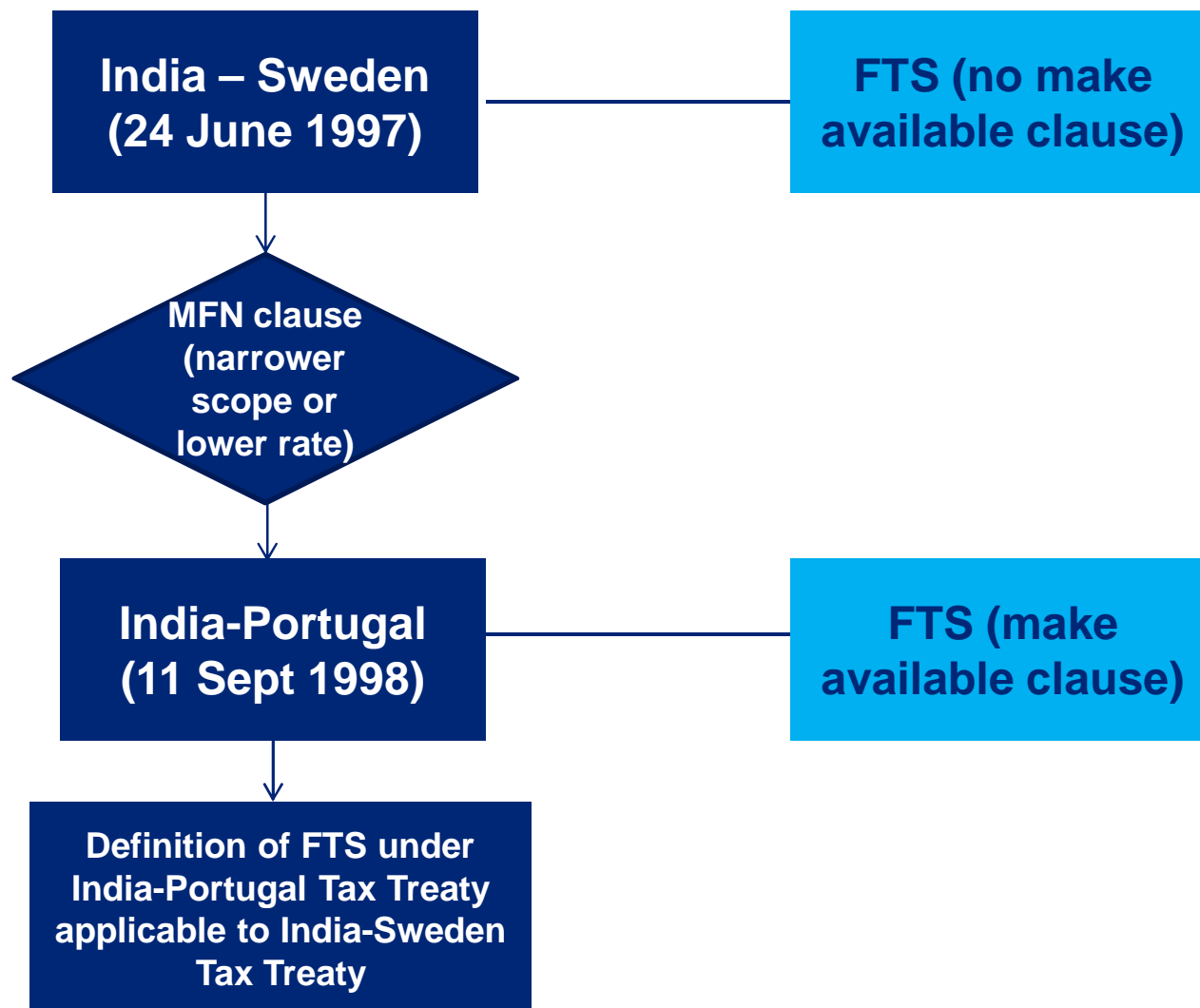
- UN Model
- In 1979, Manual for the negotiation of Bilateral Tax Treaties between developed and developing countries was adopted
- The final Model Convention was adopted with commentaries and reviewed in 2001
- US Model: revising its first model in 1996 and revised again in 2006



## Most Favoured Nation Clause (1/2)

- More favourable terms granted to other countries extended to existing treaty countries
- Lower tax rate
- Narrowing scope of income liable to tax
- Binds the contracting country to offer to the other contracting country the same benefits which first country may have offered to a third country
- Generally MFN status provided under the protocol/ exchange of notes

## Most Favoured Nation Clause (2/2)



India has MFN clauses in tax treaties with Belgium, Finland, France, Hungary, Israel, Kazakhstan, Netherlands, Spain, Sweden, Switzerland, etc.

## Interpretation of tax treaties (1/3)

- Need for interpretation of tax treaty
  - A treaty results from negotiation and compromise between two conflicting interest and such compromises is not necessarily drafted in legislative jargon
  - Treaties are drafted by diplomats who may not use language in precise legislative manner as the legal draftsman does while drafting the statute
  - Treaties are entered into at political level and have various consideration as basis

Observation by Supreme Court –  
UOI v. Azadi Bachao Andolan  
263 ITR 706

## Interpretation of tax treaties (2/3)

### International Law - Vienna Convention

- Signed on 23 May 1969; entered into force on 27 January 1980
- Article 26: Every treaty in force is binding upon the parties to it and must be performed by them in good faith
- Article 31(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
- Article 31(4): Special meaning only if specifically intended by parties
- Article 32: Supplementary means to be used only to confirm the meaning
- Article 34: A treaty does not create either obligations or rights for a third state without its consent

## Interpretation of tax treaties (3/3)

The Mumbai Tribunal in case of Linklaters LLP (132 TTJ 20) has relied on the principles governing interpretation of Tax Treaties summarised in case of ***Hindalco Industries Ltd.*** (94 ITD 242) as under:

1. A tax treaty is an agreement and not taxing statute
2. A tax treaty is to be interpreted in good faith in accordance with the ordinary meaning given to the treaty in the context and in the light of its objects and purpose.
3. A tax treaty is to required to be interpreted as a whole, which essentially implies that the provisions of the treaty are required to be construed in harmony with each other.
4. The words employed in the tax treaties not being those of a regular Parliamentary draughtsman.
5. A literal or legalistic meaning must be avoided when the basic object of the treaty might be defeated or frustrated insofar as particular items under consideration are concerned. Words are to be understood with reference to the subject-matter.

# Anatomy of tax treaty

An Indian Tax treaty has seven chapters:

Chapter	Particulars
I	Scope Of Convention
II	Definitions
III	Taxation of Income
IV	Taxation of Capital
V	Methods of Elimination of Double Taxation
VI	Special Provisions
VII	Final Provisions

# Chapter I: Scope of Convention

- Article 1: General Scope
  - Applies to persons who are residents of one or both of the Contracting States
- Article 2: Taxes Covered
  - Applies to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied
  - Also applies to any identical or substantially similar taxes that are imposed after the treaty is signed in addition to, or in place of, the existing taxes

## Chapter II: Definitions (1/2)

- Article 3 – General Definitions
  - It defines some terms designated as ‘general’ which are necessary for the understanding and application of bilateral tax convention.
  - These terms are; person, company, enterprise, enterprise of a Contracting State, international traffic, national etc.
- Article 4 - Resident
  - Paragraph 1: Liability to tax the person by reason of domicile, residence, place of management or any other criterion of a similar nature and (UN only) place of incorporation
  - Paragraph 2: Liability to tax the person, if resident of both Contracting States under the respective domestic laws, by reason of permanent home, centre of vital interest, habitual abode, nationality and mutual agreement
  - Paragraph 3: Double residency of companies and other bodies of persons irrespective whether they are legal or not



## Chapter II: Definitions (2/2)

- Article 5 – Permanent Establishment  
Types of PE
  - Fixed place PE
  - Service PE
  - Agency PE
  - Construction PE
  - Exclusion

## Chapter III: Taxation of Income (1/4)

- Article 6 – Income from immovable property
  - Unrestricted taxation by the source country allowed
- Article 7 – Business Profits
  - Deals with the PE principle and attribution of profits once a PE has come into existence
  - Force of attraction principle – abandoned by the OECD
  - Special provisions excluded from the scope of Article 7
- Article 8 – Income from shipping, inland waterways transport and air transport
  - Applies to international taxation only
  - Place of deemed accrual of profits arising from activities
  - Exclusive taxation by the country of residence or where the place of effective management is located
- Article 9 – Associated Enterprise
  - Enterprises under common management and taxation of profits owing to close condition (other than transactions of arm's length price)

## Chapter III: Taxation of Income (2/4)

- Article 10 – Dividends
  - Taxation by source country (5% to 15%)
- Article 11 – Interest
  - Taxation by source country (10%)
  - Concessional rate of tax in certain situations
- Article 12 – Royalties
  - Exclusive taxation by the country of residence
- Article 13 – Capital Gains
  - Taxation by source country limited to gains on immovable property and business assets of a PE
  - Concessional rates/exemption from tax, if any
  - Indo-Mauritius Tax treaty
- Article 14 – Independent Personal Services
  - Applies to professional services rendered by an individual or a firm
  - Article deleted by OECD Model in 2000

## Chapter III: Taxation of Income (3/4)

- Article 15 – Dependent Personal Services
  - Taxation of employment income by source country but exemption if employee is present for less than 183 days and the employer is non-resident
- Article 16 – Director's Fees
  - Taxation by the country of residence of the company
- Article 17 - Artistes and Sportsmen
  - Taxation by source country is allowed
  - Look through interposed entities
- Article 18 – Pension
  - Exclusive taxation by country of residence
- Article 19 – Government Service
  - This does not apply where services are rendered in connection with any trade or business

## Chapter III: Taxation of Income (4/4)

- Article 20 – Students
  - Payments from outside country of study not taxable
  - Source country also exempts income up to a certain limit
- Article 21 – Other Income
  - Exclusive taxation by country of residence except if income relates to PE

## Chapter IV: Taxation of Capital

- Article 22 – Capital
  - Source country taxation allowed for:
    - a. Immovable property
    - b. Business assets of a PE or a fixed base

# Chapter V: Methods of elimination of double taxation

- Article 23 – Elimination of double taxation
  - Methods for elimination of double taxation
    - a. Exemption method
    - b. Credit method

## Chapter VI: Special Provisions

- Article 24 – Non discrimination
- Article 25 – Mutual agreement procedure
- Article 26 – Exchange of Information
- Article 27 – Assistance in the collection of taxes
- Article 28 – Members of diplomatic missions and consular posts
- Article 29 – Territorial extension



## Chapter VII: Final Provisions

- Article 30 – Entry into force of the convention
  - Date of entry into force
  - Date of effect
- Article 31 – Termination of the convention

## How is treaty applied

Step 1 : Determine if the issue is within the scope of the convention

Step 2 : Apply the relevant definitions

Step 3 : Determine which of the Articles and its substantive provisions apply

Step 4 : Apply the substantive Article

Step 5 : Apply the provision for the elimination of double taxation

Step 6 : Follow the treaty provisions in to the domestic law of two states

# Open House

*Thank you*