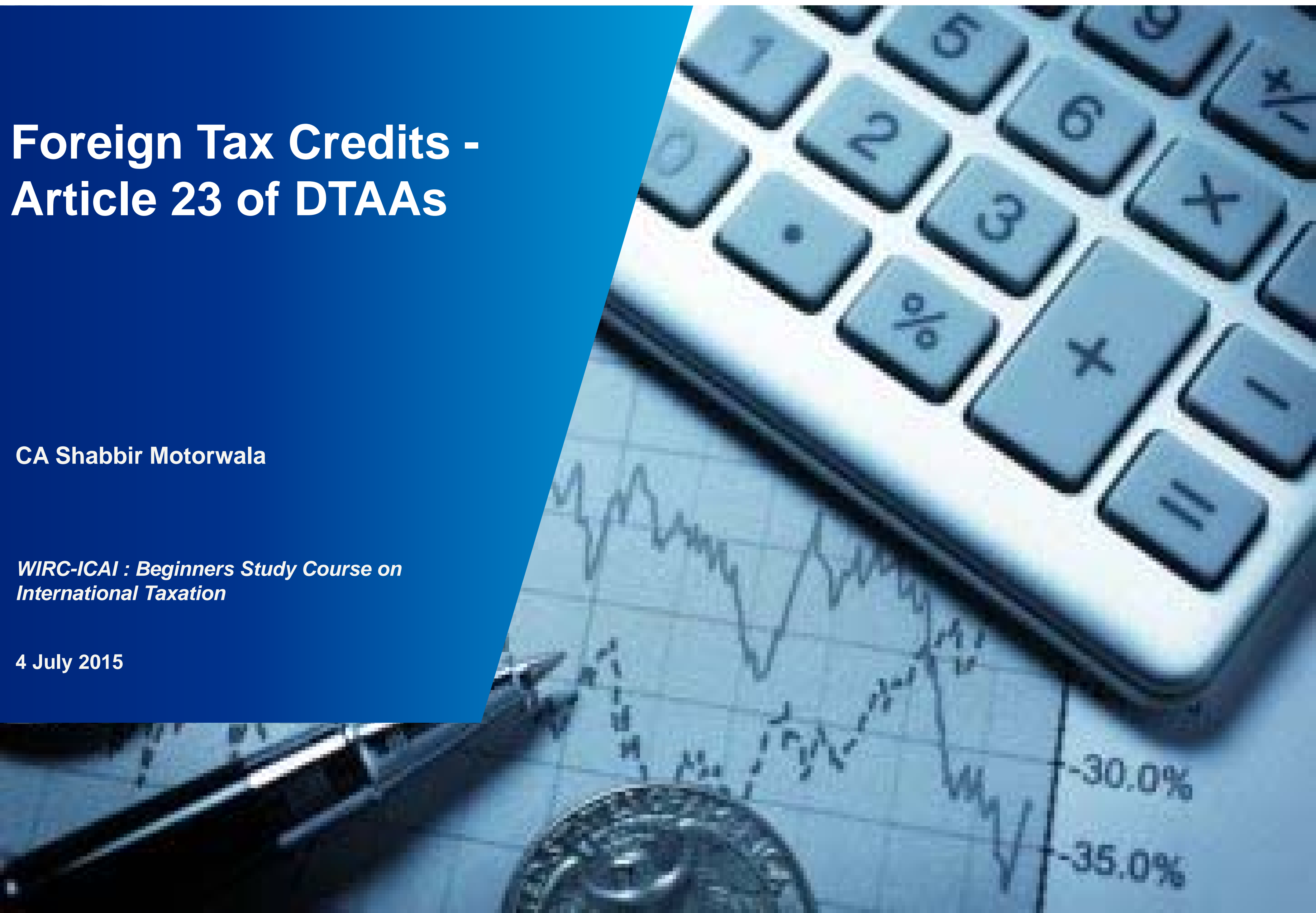
Foreign Tax Credits -
Article 23 of DTAAs
CA Shabbir Motorwala
WIRC-ICAI : Beginners Study Course on
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Types of Double Taxation

Juridical Double Taxation

- **Same person is taxed on the same income in more than one State – say in the following cases:**
  - Worldwide Income taxable in more than one State
  - Taxation as per Residence rule in one State and Source rule in the other State
  - Triangular Taxation e.g. PE in Source State deriving income from various other States

Economic Double Taxation

- **Two separate persons are taxed on the same income in more than one State – say in the following cases:**
  - Taxation in source country of partnership entity as separate taxable entity and in the residence country, partners of such partnership taxable on pass through principles
  - Foreign income of overseas company taxed and dividend declared therefrom taxable again for shareholders

Tax Treaties and Model Convention address Juridical Double Taxation and not Economic Double Taxation

Elimination of Double Taxation

- **Allocation of Right to Tax**
  - Renunciation of right to tax by either state - income taxable only in One State
  - Sharing of rights - Generally Resident State will provide relief for taxes paid in Source State
- **Foreign Tax Credit - Types of Tax Relief**
  - **Unilateral Tax Relief**
    - Relief as per domestic income tax provisions e.g. Section 91 of the Income-tax Act 1961
  - **Bilateral Tax Relief**
    - Relief as per mutual covenants / DTAAs – Article 23 read with domestic income-tax provisions (Section 90)
    - Relief via DTAAs generally more beneficial than the domestic tax laws
    - DTAA restrict a country's ability to unilaterally override provisions in DTAA to the detriment of taxpayers
    - OECD MC – Contracting state to decide which method to use i.e. Exemption Method or Credit Method

India – Unilateral Tax Credit

Section 91 of the Income-tax Act 1961:

- Applicable to cases where there is no DTAA with foreign country in which tax is paid / liability incurred
- Quantum of Relief
    - Proportionate method i.e. lower of 'Indian Tax Rate' or ' Foreign Tax Rate' (Ordinary Credit method and not full method)

Broad principles of Section 91:

- Available to persons who are resident in India
- Available on income accruing or arising outside India
- Available for taxes paid in foreign country on such income either by way of deduction or otherwise
- Onus of proof on the person claiming the tax credit
- Indian tax rate = Indian income tax net of double tax relief / total income
- Foreign tax rate = Foreign income tax net of any double tax relief / income assessed in that country

Unilateral Tax Relief – Simple Illustration

Particulars		Case I	Case II
Income in India		150,000	150,000
Income in foreign country		100,000	100,000
Total income		250,000	250,000
Tax rate in India		30%	30%
Tax rate in foreign state		25%	35%
Workings			
Income tax on total income	(A)	75,000	75,000
Indian tax on foreign income	(B)	30,000	30,000
Foreign tax on foreign income	(C)	25,000	35,000
Unilateral tax relief as per the Act – Lower of (B) or (C)	(D)	25,000	30,000
Tax payable in India (A) – (D)	(E)	50,000	45,000
Total tax outflow (B) + (E)		75,000	80,000
Effective tax rate		**30%**	**32%**

India – Bilateral Tax Credit

Section 90 of the Income-tax Act 1961:

- Central Government empowered to enter into DTAA with Specified Territory outside India inter alia for granting of relief in respect of doubly taxed income or income doubly chargeable to tax
- Article 23 of the Model Convention / DTAAs governs the mechanism of eliminating double taxation

Methods envisaged under Article 23:

Exemption Method

- Full Exemption
- Exemption with progression

Credit Method

- Direct Credit
  - Full Credit or Ordinary Credit
- Indirect Credit – Underlying Tax Credit
- Special Credit - Tax Sparing

Two contracting states in DTAAs can agree to follow different methods for eliminating double taxation

Relevant Text of Articles 23A / 23 B of OECD Model:

Article 23A – Exemption Method

1. "Where a resident of a Contracting State (A) derives income..... which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State (B), the first-mentioned State (A) shall, ..., exempt such income .... from tax.

2. ....(exclusions for Dividend / Interest income – Credit Method)

3. Where in accordance with any provision of the Convention income derived by a resident of a Contracting State (A) is exempt from tax in that state (A), such State (A) may nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income ....

4. ....(exclusions for Dividend / Interest income – Credit Method)

The Exemption Method

- **Full Exemption Method**
  - The whole income which is taxed in the Source country is exempt i.e. not taken into account by the Resident Country for its tax purposes
  - In determining the tax on the rest of the income in the Resident country, the income taxable in the Source country is not considered
- **Exemption with Progression Method**
  - The whole income which is taxed in the Source country is exempt i.e. not taken into account by the Resident country for its tax purposes
  - In determining the tax on rest of the income in the Resident Country, the income taxable in Source Country is considered. Therefore, level of income in Source Country matters.
- **Key aspects surrounding the Exemption method**
  - Reduces the tax share of Resident country
  - Encourages use of low-tax countries as Source country
  - May result in Double non-taxation where Source country also exempts such income notwithstanding its right to tax e.g. Mauritius in the context of capital gains Article in the India-Mauritius DTAA

Full Exemption Method- Illustration

Resident country	Amount (In INR)
Income	80,000
Tax rate	
Upto 80,000	30%
Above 80,000	35%

Source country	Situation I	Situation II
Income	20,000	20,000
Tax rate	20%	40%
Tax amount	4,000	8,000

Particulars		Situation I	Situation II
Income in Resident country for tax rate purposes			
Resident country	(a)	80,000	80,000
Source country		0	0
Total		80,000	80,000
Tax			
Tax rate in Resident country		30%	30%
Resident country	(b) = tax rate on (a)	24,000	24,000
Source country		4,000	8,000
Total		28,000	32,000
Relief in Resident country			
Total income		100,000	100,000
Total tax	(c)	35,000	35,000
Total	(c) – (b)	11,000	11,000

Exemption with Progression Method - Illustration

Resident country	Amount (In INR)
Income	80,000
Tax rate	
Upto 80,000	30%
Above 80,000	35%

Source country	Situation I	Situation II
Income	20,000	20,000
Tax rate	20%	40%
Tax amount	4,000	8,000

Particulars		Situation I	Situation II
Income in Resident country for tax rate purposes			
Resident country	(a)	80,000	80,000
Source country		20,000	20,000
Total		100,000	100,000
Tax			
Tax rate in Resident country		35%	35%
Resident country	(b) = tax rate on (a)	28,000	28,000
Source country		4,000	8,000
Total		32,000	36,000
Relief in Resident country			
Total income		100,000	100,000
Total tax	(c)	35,000	35,000
Total	(c) – (b)	7,000	7,000

Relevant Text of Articles 23A / 23 B of OECD Model:

Article 23B – Credit Method

1. "Where a resident of a Contracting State (A) derives income .... which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State (B), the first mentioned State (A) shall allow:

   as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State (B);

   Such deduction .... shall not, however, exceed that part of the income tax ...., as computed before the deduction is given, which is attributable ...., to the income .... which may be taxed in that other State (B).

2. Where in accordance with any provision of the Convention income derived by a resident of a Contracting State (A) is exempt from tax in that state (A), such State (A) may nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income ....

Credit Methods

- **Credit Method**
  - Under this method, the Resident country grants credit for the taxes paid in the Source country
  - For the resident country, the loss of revenue is generally lower in credit method, therefore generally most DTAAs relieve double taxation only through credit method
  - Non-refundable tax credit – In case the tax payable in Resident country is less than the credit available or the relevant income is exempt in Resident country, the resident is not entitled to refund of the excess credit for the taxes paid in Source state
- **Key variants**
  - **Full credit** – Resident state grants credit for the taxes paid in the Source country without any restriction
  - **Ordinary credit** – Tax credit is restricted to lower of the taxes to be paid in the Resident country or the actual taxes discharged in the Source country
  - **Tax Sparing** – Refer slide no. 15
  - **Underlying Tax Credit** – Refer slide no. 17

Full Credit

- Under this method, the residence country exempts the taxes paid in the source country
- OECD Model Convention
- Article 23 of India – Namibia DTAA

Particulars		Case I	Case II
Assumptions		Amount in INR	Amount in INR
Income in State R		80,000	80,000
Income in State S		20,000	20,000
Aggregate taxable income in State R		100,000	100,000
Tax rate in State R		35%	35%
Tax rate in State S		20%	40%
Workings			
Tax payable in State R	(A)	35,000	35,000
Tax payable in State S	(B)	4,000	8,000
Total tax credit (credit for full taxes paid) (C) = (B)	(C)	4,000	8,000
Total tax after relief – (A) – (C)	(D)	31,000	27,000

Ordinary Credit

- Under this method, tax credit is restricted to lower of
  - The taxes to be paid in the Resident state; or
  - The actual taxes discharged in the Source state
- Article 25 of India – USA DTAA

Particulars		Case I	Case II
Assumptions		Amount in INR	Amount in INR
Income in State R		80,000	80,000
Income in State S		20,000	20,000
Aggregate taxable income in State R		100,000	100,000
Tax rate in State R		35%	35%
Tax rate in State S		20%	40%
Workings			
Tax payable in State R	(A)	35,000	35,000
Tax payable in State S	(B)	4,000	8,000
Taxes in Resident state on income from Source state (20,000 * 35%)	(C)	7,000	7,000
Total tax credit - Lower of (B) & (C)	(D)	4,000	7,000
Total tax after relief – (A) – (D)	(E)	31,000	28,000

Tax Sparing

- The Source State generally grant incentives to foreign investors for the purpose of attracting foreign investments which get neutralized if the State of Residence taxes them fully on the basis of no taxation in State of Source
- Tax Sparing is the allowing of relief by State of Residence of those foreign taxes which have been spared under the incentive program of the State of Source
- Tax Sparing by State of Residence may be in the form of
  - Deduction / credit for taxes not levied / spared by the State of Source
  - Fictitious higher tax credit to the extent of tax reduction by the State of Source
  - Exemption of income which has benefitted from the tax incentives
- Tax Sparing relevant to income such as interest, royalties, foreign branch / permanent establishment income, etc.
- The concept of tax sparing may lead to double non-taxation
- Many Indian Tax Treaties contain tax sparing clauses

Tax Sparing Credit - Illustration

Particulars		Tax sparing – Absent	Tax sparing – Present
Assumptions		Amount in INR	Amount in INR
Income in State R		80,000	80,000
Income in State S		20,000	20,000
Aggregate taxable income in State R		100,000	100,000
Tax rate in State R		35%	35%
Tax rate in State S (exempted 30%) - normal rate - special rate		30% 0%	30% 0%
Workings			
Tax payable in State R	(A)	35,000	35,000
Tax payable in State S	(B)	-	-
Tax credit (tax charged in State S)	(C)	-	-
Tax credit (tax exempted in State S) (20,000 * 30%)	(D)	-	6,000
Total tax credit (C) + (D)	(E)	-	6,000
Total tax after relief – (A) – (E)	(F)	35,000	29,000

Underlying Tax Credit

- The concept of Underlying Tax Credit is relevant to Dividend income
- It eliminates ‘economic double taxation’ i.e. same income taxed twice in the hands of two or more persons
- Meaning of Underlying Tax Credit - Credit is granted by Resident country
  - For the taxes withheld on dividends; and
  - For the corporate taxes paid on the underlying profits out of which dividends has been paid
- Underlying Tax Credit relief may only apply / be eligible on satisfaction of substantial shareholding requirements.
- Example of Indian Tax treaties that stipulate Underlying Tax Credit:
  - Article 24 of India – UK DTAA
  - Article 23 of India – Mauritius DTAA
  - Article 25 of India – Singapore DTAA

Underlying Tax Credit - Illustration

Particulars		Amount in INR
Taxation of Indian Subsidiary Co of UK Holding Co In India		
Profit of Subsidiary Co in source state (India)		100,000
Taxes (30%)		(30,000)
Profit after tax		70,000
Dividend distributed		50,000
Dividend paid to UK Holding Co (70% holding)		35,000
Dividend Distribution Tax on above (15%)	(A)	(5,250)
Taxation of UK Holding Co in UK		
Profit of UK Holding Co in UK		200,000
Dividend income		35,000
Taxable income		235,000
Tax Rate (40%)	(B)	94,000
Underlying Tax Credit [35,000 * 30,000 / 70,000]	(C)	(15,000)
Total Tax Credit (A) + (C)	(D)	20,250
Total Tax after Relief		73,750

Key points surrounding Foreign Tax Credits ('FTC') – 1 of 2

- FTC to be considered in computation of Advance Tax
  - No express provision in Sections 207 to 209.
  - Section 234B & 234C – permit credit for FTC immediately after domestic TDS
- The Finance Act 2015 introduced clause (ha) in Section 295(2)(ha)
  - CBDT to make rules for granting relief u/s 90/ 90A/91 for the foreign tax paid. Applicable w.e.f. 1 June 2015.
- General documentation required to support FTC
  - Overseas Tax withholding certificates or similar evidence for deduction / payment of taxes
  - Overseas Tax payment challans into Bank / Government treasury
  - Overseas Tax Returns
  - Tax payment certificate from Foreign Tax authorities

Key points surrounding Foreign Tax Credits ('FTC') – 2 of 2

- Under Article 23 / Section 91 - the amount of FTC that can be claimed in India is the lower of:
  - The amount of foreign income tax paid; or
  - The amount of income tax chargeable on that foreign source income in India
- In view of above, there may arise excess FTC i.e. Income tax paid in the foreign country which is higher than the amount of income tax payable in India on that foreign source income
- There is no carry forward of excess FTC under the Income-tax Act / DTAAs
  - Countries such as Canada and USA allow carry forward of excess FTC
- The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015
  - No specific provision under the to grant relief against double taxation of income.
  - It seems that the Foreign Tax paid will not be allowed as a credit.
  - Adds to the compliance costs of people who may want to avail this scheme

Selected Judicial Precedents

- **Vijay Electricals [2015] 54 taxmann.com 19 (Hyd AT)**
  - Eligible to claim entire TDS credit even if the payer has not deposited the same with overseas Government in the year of taxability
- **Hindustan Construction [2013] 29 taxmann.com 82 (Mum AT)**
  - Entitled to relief under Section 91 at average rate of tax paid (i.e. tax paid divided by book profits from operations in Bhutan) which is subject to tax in both countries
- **Petroleum India [2013] 29 taxmann.com 250 (Bom HC)**
  - Entitle to relief under Section 91 for taxes paid outside India and the relief is not dependent upon payment being made in relevant previous year
- **Tata Sons [2011] 43 SOT 27 (Mum AT)**
  - US State Tax to be eligible as credit under Section 91 inspite of India-US DTAA providing only for Federal Tax Credit.
- **Best & Crompton [2006] 156 Taxman 216 (Mad HC)**
  - Eligible to claim unilateral relief under section 91 without taking into account weighted deduction allowed under Section 35B (now deleted) in respect of Iranian income

Some practical issues surrounding FTC

- What exchange rate to be used for calculating FTC?
  - Income booked rate or realized rate of later year?
  - Rate prevalent on payment / deduction date? What if this date is post filing the return?
  - What if the currency of billing and local currency in which tax is paid / deducted are different?
- Whether foreign income and foreign losses from two or more foreign states need to be aggregated or FTC is eligible each country-wise?
- Whether FTC is eligible when tax is payable by Indian Company under MAT?
- Whether FTC is eligible for partnership firms which are treated as separate entity in India but taxes paid in Source Country by Partners?

Questions

&

Answers

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Thank You!