

Deloitte Haskins & Sells LLP

OECD Model Tax Convention on Income and Capital – *An overview*

CA Vishal Palwe, 3 July 2015



Contents

Overview of double taxation	3
Basics of tax treaty	6
Domestic law and tax treaty	11
Key provisions of Income-tax Act for non-residents	15
Model tax conventions	18
Articles in OECD MC	25
Select concepts in international taxation	52

Overview of double taxation

Overview of double taxation

Types

- Double taxation may be classified into broadly two categories: (i) juridical double taxation and (ii) economic double taxation
- Juridical double taxation
 - Same income is taxed by two countries in the hands of the same person
 - e.g. Royalties taxable in the source state as well as resident state
- Economic double taxation
 - Same income is taxed by two countries in the hands of different persons
 - e.g. Taxation of subsidiary by one contracting state and the taxation of the parent on dividend from that subsidiary by another contracting state
- Tax treaties resolve juridical double taxation and not economic double taxation

Overview of double taxation

Conflicts of residence and source rules

- Double taxation arises owing to conflict of residence and source rules
- Each contracting state provides for taxation of specified income on the basis of the residence of the taxpayer or on the basis of the source of income of the taxpayer
 - Two or more countries claim the same income of a taxpayer as sourced in their own state (source – source conflict)
 - Two or more countries claim that the same taxpayer as a tax resident of their own state (residence – residence conflict)
 - One state taxes the income under its source rules and the other state in which the taxpayer is a resident taxes the same income under its residence rules (residence – source conflicts)
 - This is the most common type of juridical double taxation

Basics of tax treaty

Basics of tax treaty

Role of tax treaty

- Tax treaties are agreements between sovereign states governed by the broad legal framework of the Vienna Convention on the law of treaties
- Primary objective of bilateral tax treaties is to eliminate double taxation
 - Tie-breaker rules for residential status to ensure that a taxpayer is resident of one state only
 - Distributive rules to divide rights between residence state and source state
 - Mechanism to provide foreign tax relief
- Elimination of non-discrimination against non-resident taxpayers
- Exchange of information between two states to counter fiscal evasion
- Mechanism to resolve disputes such as mutual agreement procedure

Basics of tax treaty

Interpretation of tax treaties

- Internationally accepted methods of treaty interpretation include:
 - Text of the treaty
 - Negotiating history – *travaux préparatoires*
 - Domestic ratification documents
 - Subsequent practices / judicial precedents
 - Vienna Convention on the Law of Treaties

Basics of tax treaty

Sources of interpretation

- Commentaries and judicial pronouncements
 - OECD / UN Model Commentaries represent ‘international tax language’ and has generally received due respect
 - References by Courts to ‘reinforce’ or ‘confirm’ conclusion; in some cases, even ‘followed’ the commentaries
 - Foreign Court judgments
- Books and journals on international taxation

Basics of tax treaty

Protocol to tax treaties

- The protocol to a tax treaty explains or modifies the provisions of the tax treaty
- Items typically covered by protocols
 - Scope of permanent establishment
 - Computation of business profits
 - Scope of taxation of royalties / fees for technical services
 - Most favoured nation (MFN) clause
 - Taxation of capital gains
- Important protocols in India's tax treaties:
 - India-US tax treaty: Explanation of the 'make available' principle
 - India-Singapore tax treaty: Taxation of capital gains

Domestic law and tax treaty

Domestic law and tax treaty

- If no tax liability is imposed under the Income-tax Act, there would be no need to claim a tax treaty benefit
- If a tax liability is imposed under the Income-tax Act, the tax treaty may be applied to reduce tax liability
- Section 90 of Income-tax Act, 1961 allows a non-resident taxpayer to choose between provisions of Income-tax Act and tax treaty, whichever is beneficial

Nature of income	Income-tax Act	Tax treaty
Business or profession	Section 9(1)(i)	Articles 5, 7, 14
Salary income	Section 9(1)(ii)	Article 15
Dividend income	Section 9(1)(iv) and 115A	Article 10
Interest income	Section 9(1)(v) and 115A	Article 11
Royalties	Section 9(1)(vi) / (vii) and 115A	Article 12
Capital Gains	Section 9(1)(i) and 45	Article 13

Domestic law and tax treaty

- Tax treaty and General Anti-Avoidance Rule (GAAR)
 - As per section 90(2) of the Act, GAAR provisions under Chapter X-A of Act shall apply to the taxpayer even if provisions of the Act are not beneficial to the taxpayer (inserted vide Finance Act 2013 and to be effective from 1 April 2016)
- List of documents that are a must for claiming tax treaty benefit
 - Tax Residency Certificate (TRC) issued by home country of the non-resident in terms of tax treaty with India as per section 90(4) of the Act
 - Declaration in Form 10F (if required) as prescribed by Income-tax Rules

Domestic law and tax treaty

- Central government has power to enter into tax treaty with government of another country under the delegated legislation granted by the parliament
- The power of the Central Government is co-extensive with the legislature power of the parliament under Article 73 of the Indian Constitution to make or implement a treaty with the government of another country
- Article 51 (Part IV) of the Indian Constitution sets out that India shall endeavor to foster respect for international law and treaty obligations in the dealings of organised people with another
- The tax treaty does not have to be laid before the parliament since no legislation is required to give effect to a treaty – *Meganbhai v. UOI* (1969) SC 783; however, a formal approval of the tax treaty by notification or such other means of ratification is required

Key provisions of Income-tax Act for non- residents

Key provisions of Income-tax Act for non-residents

- Charging section (section 4)
- Scope of total income (section 5)
- Income deemed to be accrued or received (section 9)
- Business connection (section 9(1)(i))
- Definition of royalty income (section 9(1)(vi))
- Definition of fees for technical services (section 9(1)(vii))

Key provisions of Income-tax Act for non-residents

- Royalties / Fees for technical services (Section 115A read with section 44DA)
 - Royalties / Fees for technical services would be taxable at 10% (plus applicable surcharge and cess) on gross basis; if the non-resident has a PE in India, such income would be taxable as business income at 40% (plus applicable surcharge and cess) on net basis
- Interest
 - Interest would be taxable at 10% (plus applicable surcharge and cess) on gross basis; if the non-resident has a PE in India, such income would be taxable as business income at 40% (plus applicable surcharge and cess) on net basis
- Dividend
 - Dividend is not taxable in India in the hands of the non-resident where Indian company has paid Dividend Distribution Tax (DDT)

Key provisions of Income-tax Act for non-residents

- Shipping business (section 44B)
 - Profits and gains from such business is deemed to be 7.5% of total gross amounts which would be taxable at 40% (plus applicable surcharge and cess)
- Business of exploration, etc., of mineral oils (section 44BB)
 - Profits and gains from such business is deemed to be 10% of total gross amounts which would be taxable at 40% (plus applicable surcharge and cess)
- Foreign Institutional Investors (FIIs) (section 115AD)
 - Income (other than dividend under section 115-O) received by FIIs in respect of securities (other than section 115AB) would be taxable at 20% (plus applicable surcharge and cess)
 - Short term capital gains (other than section 111A) taxable at 30% (plus applicable surcharge and cess)
 - Long term capital gains taxable at 10% (plus applicable surcharge and cess)

Key provisions of Income-tax Act for non-residents

- Operation of aircrafts (section 44BBA)
 - Profits and gains from such business is deemed to be 5% of total gross amounts which would be taxable at 40% (plus applicable surcharge and cess)
- Business of civil construction, etc. (section 44BBB)
 - Profits and gains from such business is deemed to be 10% of total gross amounts which would be taxable at 40% (plus applicable surcharge and cess)
- Non-resident sportsmen (section 115BBA)
 - Income received by non-resident sportsmen, sports associations and entertainers would be taxable at 20% (plus applicable surcharge and cess)

Key provisions of Income-tax Act for non-residents

- Foreign Institutional Investors (FIIs) (section 115AD)
 - Income (other than dividend under section 115-O) received by FIIs in respect of securities (other than section 115AB) would be taxable at 20% (plus applicable surcharge and cess)
 - Short term capital gains (other than section 111A) taxable at 30% (plus applicable surcharge and cess)
 - Long term capital gains taxable at 10% (plus applicable surcharge and cess)

Model tax conventions

Model tax conventions

OECD MC

- 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 – mostly commonly used for bilateral treaties
- India not a OECD member; currently has been granted ‘Observer’ status
- Key points:
 - Lays emphasis on the right of State of residence to tax
 - Royalty taxation in the residence State
 - Excludes taxation on services
- The Commentaries have been referred to as an aid to interpretation by Courts in OECD and as well as non-OECD countries

Model tax conventions

UN MC

- United Nations [UN] drafted UN MC in 1980, designed to encourage flow of investments from the developed to developing countries
- Tax treaties between developed and lesser developed countries, or between 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
- Most of India's tax treaties are based on UN MC
- Key points:
 - Payer of income is considered as source of taxation
 - Service fee made taxable
 - Reduced threshold for PE

Model tax conventions

US MC

- US has developed its own Model Convention
- Objective of the convention
 - US, being capital exporting country, for protecting its taxing rights on the worldwide income of its residents
- Based on OECD model convention
 - However, certain concepts picked from UN model convention as well like ‘make available’ concept, service PE, force of attraction, etc.
- US technical explanations

Model tax conventions

Structure of OECD MC

- Chapter I (Articles 1 & 2): Scope of the Convention
- Chapter II (Articles 3 to 5): Definitions of some general and specific terms
- Chapters III & IV (Articles 6 to 22): Allocation of taxation rights between the two Contracting States
- Chapter V (Articles 23): Methods for elimination of double taxation
- Chapter VI (Articles 24 to 29): Special provisions like non-discrimination, mutual agreement procedure, exchange of information, etc.
- Chapter VII (Articles 30 & 31): Entry into force and termination

Model tax conventions

Distributive rules under OECD MC

- Distributive rules are contained in chapters III & IV (Articles 6 to 22): Allocation of taxation rights between the two Contracting States
- Distributive rules to divide rights between residence state and source state
 - The source country or the residence country has the exclusive right to taxation
 - “shall be taxable only” in a particular country
 - The residence and source country both have non-exclusive rights to taxation (source country may have right to limited taxation or source country may have right to full taxation)
 - “may be taxed” in other country

Model tax conventions

Relief rules under OECD MC

- If juridical double taxation is not relieved by distributive rules, the relief rules have to be resorted to contained in Chapter V (Articles 23): Methods for elimination of double taxation
- Generally, relief is granted using the following methods and by the country of residence of the taxpayer
 - Full exemption method
 - Exemption with progression method
 - Full credit method
 - Ordinary credit method

Articles in OECD MC

Articles in OECD MC

Scope

Article 1 of OECD MC

- Convention shall apply to persons who are residents of one or both of the Contracting states
 - The term ‘person’ includes an individual, a company and any other body of persons (Article 3)
 - Meaning of the term ‘resident of a Contracting State’ (Article 4)

Articles in OECD MC

Taxes covered

Article 2 of OECD MC

- Tax treaty would apply to all taxes on income and capital irrespective of the manner in which it is levied (Article 2.1)
- Taxes on income and capital to include (Article 2.2):
 - Taxes imposed on total income or capital
 - Taxes on gains from the elimination of movable or immovable property
 - Taxes on total amount of wages or salaries
 - Taxes on capital appreciation
- Contracting states to clarify taxes that would be covered by tax treaty (Article 2.3)
- Taxes would also include identical or similar taxes imposed in place of existing taxes after the date of signature of the treaty (Article 2.4)

Articles in OECD MC

General definitions

Article 3 of OECD MC

- Article 3 contains a list of definitions of various terms that have been used in tax treaty
- Key points:
 - For the purposes of tax treaty
 - Unless the context otherwise requires

Articles in OECD MC

Residence

Article 4 of OECD MC

- Treaty definition of “resident of a contracting state” means a person who under the domestic tax laws is liable to tax therein by reason of domicile, residence, place of effective management or any other criterion of similar nature (Article 4.1)
- Tie-breaker tests for individuals (Article 4.2)
 - Permanent home
 - Centre of vital interests
 - Habitual abode
 - Nationality
 - Mutual agreement between the two contracting states
- Tie-breaker test for other than individuals is place of effective management (Article 4.3)

Articles in OECD MC

Permanent establishment

Article 5 of OECD MC

- As per Article 7, business income of an enterprise may be taxed in source state only if it has a permanent establishment (PE) as per Article 5 in source state
- Fixed place PE (Article 5.1 and 5.2): A fixed place of business through which the business of an enterprise is wholly or partly carried on. A list of fixed place of business provided at Article 5.2
- Construction PE (Article 5.3): A building site or construction or installation project if it lasts for more than 12 months
- Agency PE (Article 5.5. and 5.6): If an enterprise carries on business activities (specific activities such as habitually acting on behalf of the principal, etc.) through persons other than independent agents
- Exceptions (Article 5.4): Preparatory / auxiliary activities are exceptions to PE
- Concept of Service PE is not a part of OECD MC

Articles in OECD MC

Income from immovable property

Article 6 of OECD MC

- Article 6 grants non-exclusive right to tax income derived from the direct use, letting, or use in any other form of immovable property to the state of source where the immovable property is situated (Article 6.1 and 6.3)
- Treaty definition of the term “immovable property” refers to domestic tax law of the source state; however, it lists down items that would in any case be covered by the term immovable property (Article 6.2)
- Income derived by an enterprise from immovable property would also be covered (Article 6.4)

Articles in OECD MC

Business profits

Article 7 of OECD MC

- Article 7 deals with taxation of business profits of a resident of a state arising in the other state
- The source state has the right to taxation if resident of a state has a permanent establishment (as per in Article 5)
 - Income that is attributable to the permanent establishment is taxable in source state
- If the resident of a state does not have permanent establishment, the residence state has the exclusive right to taxation on the business profits (source states has no right to taxation)
- Force of attraction principle not contained in Article 7 of OECD MC
- Arm's length principle

Articles in OECD MC

Shipping, inland waterways transport and air transport

Article 8 of OECD MC

- Profits from the operations of ships or aircrafts in international traffic as well as operations of boats engaged in inland waterways transport
 - taxable in the state where the place of effective management of the enterprise is situated. (Article 8.1 and 8.2)
- If the place of effective management of the enterprise is situated aboard a ship / boat, it shall be deemed to be situated in:
 - State where the home harbour of the ship / boat is situated, or
 - State where the operator of the ship / boat is a resident in any other case (Article 8.3)
- Article would also apply to profits from participants in a pool, joint business or an international operating agency (Article 8.4)

Articles in OECD MC

Associated Enterprises

Article 9 of OECD MC

- Article 9 deals with transactions entered into between associated enterprises that are resident of two countries
- Meaning of the term associated enterprise (Article 9.1):
 - enterprise of one state participates directly or indirectly in the management, control or capital of an enterprise of another state
 - the same persons participate directly or indirectly in the management, control or capital of enterprises of two different states
- A Contracting state may make an adjustment to the profits on transactions entered into between associated enterprises if the transaction(s) would have differed from what transaction(s) that would have been entered into between independent enterprises
- Arm's length principle

Articles in OECD MC

Dividends

Article 10 of OECD MC

- Article 10 grants right to taxation to source state as well as residence state
- However, if the recipient of dividends in the residence state is the beneficial owner of dividends, the right to taxation of source state is limited
- Article 10.3 gives an illustrative list of items that may be considered as dividend
- Dividends effectively connected with a PE in a state are taxable under Article 7 as business profits of the PE (Article 10.4)

Articles in OECD MC

Interest

Article 11 of OECD MC

- Interest payments may be taxable in the state of residence as well as state of source (Article 11.1)
- However, interest payments effectively connected with a PE in a state are taxable under Article 7 as business profits of the PE (Article 11.3)
- Interest is deemed to arise in the state of residence of payer (Article 11.5)
- Interest defined under Article 11.2
- Article 11 does not apply in the following cases:
 - Interest is excessive or not at arm's length owing to special relationship between the payer and the beneficial owner (Article 12.4)
 - [Interest arising in third state or attributable to PE that another enterprise of the same state has in the other state – Article 21 will apply]

Articles in OECD MC

Royalties

Article 12 of OECD MC

- Royalty payments are exclusively taxable only in the state of residence (Article 12.1)
- However, royalty payments are effectively connected with a PE in a state are taxable under Article 7 as business profits of the PE (Article 12.3)
- Royalty defined under Article 12.2
- Article 12 does not apply in the following cases:
 - Recipient of royalty is not the beneficial owner
 - Royalty is excessive or not at arm's length owing to special relationship between the payer and the beneficial owner (Article 12.4)
 - [Royalties arising in third state or attributable to PE that another enterprise of the same state has in the other state – Article 21 will apply]

Articles in OECD MC

Capital gains

Article 13 of OECD MC

- General rule: The gains from alienation of property are exclusively taxable in the state in which the alienator is resident (Article 13.4).
- Exceptions:
 - Immovable property: The gains derived from alienation of immovable property may be taxed in the state in which the immovable property is situated (Article 13.1)
 - Movable business property: The gains derived from alienation of movable business property which is a part of the business assets of a PE (Article 13.2)
 - Ships / aircrafts operated in international traffic: The gains from the alienation of ships / aircraft operating in international traffic shall be exclusively taxable in the state in which the place of effective management of the enterprise is situated (Article 13.3)

Articles in OECD MC

Independent personal services

Article 14 of OECD MC

- Till 2000, Article 14 dealt with income derived from rendering of professional services or other independent activities
 - Exclusive right of taxation was granted to residence state of the taxpayer
 - However, if the taxpayer has a fixed base in the other state to which such income is effectively connected, the source state was granted right to taxation to the extent is such income is attributable to the fixed base
- Deleted from OECD MC Update 2000
- Now, income derived from rendering of professional services or other independent activities is covered under Article 7 as business income

Articles in OECD MC

Dependent personal services

Article 15 of OECD MC

- Article 15 deals with income from employment other than covered by Articles 16, 18 and 19
- The employment income as a general may be taxable in the state in which the employment is actually exercised (i.e. source state)
 - The term exercised is not defined; Place of activity or rendering of services
- Income from employment shall not be taxable in the source state, if:
 - Physical stay in source state does not exceed 183 days in 12 month period
 - Remuneration is paid by, or on behalf of, an employer who is not a resident of source state
 - Remuneration is not borne by permanent establishment which the employer has in the source state

Articles in OECD MC

Directors' fees

Article 16 of OECD MC

- Scope of the article:
 - Directors' fees and other similar payments
 - derived by a resident of a state
 - in his capacity as a member of the board of directors
 - of a company resident in another state.
- Article 16 grants non exclusive right to tax to the state in which the company is a resident.

Articles in OECD MC

Artistes and sportsmen

Article 17 of OECD MC

- Scope of the article:
 - income derived by a resident of a contracting state
 - from his personal activities as an entertainer in another contracting state
 - Entertainer includes theatre, motion picture, radio or television artiste, musician, sportsman
- Article 17 grants non exclusive right to tax to the state in which the activities are exercised, notwithstanding the provisions of Articles 7 and 15 (Article 17.1)
- If the income in respect of personal activities exercised accrues to another person, Article 17 grants non exclusive right to tax such a person to the contracting state in which the activities are exercised (Article 17.2)

Articles in OECD MC

Pensions

Article 18 of OECD MC

- Scope of the article:
 - Payments after retirement from private employment or government employment
- Article 18 grants non exclusive right to taxation to the residence state of the pensioner
- The place where the past employment was exercised or the residence of the payer of the pension does not impact the taxing rights under this Article

Articles in OECD MC

Government service

Article 19 of OECD MC

- Scope of the article:
 - Salaries, wages and other similar remunerations from government service
- Exclusive right to taxation is granted to the state that is making the payment

Articles in OECD MC

Students

Article 20 of OECD MC

- Certain overseas payments (such as maintenance, education or training, etc.) are not taxed in the state in which the student is studying or training
 - Overseas payments for the maintenance of family or for other purposes would not be exempt under this Article
- The individual must be a resident of the other state immediately before arrival and must be present in that state solely for education or training

Articles in OECD MC

Other income

Article 21 of OECD MC

- Article 21 deals with residual income
- Article 21 grants exclusive rights of taxation to the residence state if the income of a resident of a state, wherever arising, is not dealt with under the distributive rules
 - Meaning of “not dealt with” under the distributive rules
 - Applies only to taxes covered under Article 2
 - The taxpayer has to be a resident on one or both the states as per Article 1
- Exception: If income is received by a resident of a state from an activity which is effectively connected with PE in the other state, taxing rights are given to the state where there is a PE (Article 7)

Articles in OECD MC

Taxes on capital

Article 22 of OECD MC

- Article 22 deals with taxes on capital and not to income / gains from capital
- The residence state has exclusive rights to taxation with certain exceptions
- Article 22 does not apply to taxes on estates and inheritances and on gifts

Articles in OECD MC

Elimination of double taxation

Article 23 of OECD MC

- Relief from juridical double taxation (i.e. in case where same income is doubly taxed by two contracting states in the hands of the same person)
- Necessary where model treaty does not grant exclusive rights of taxation to residence or source state
- Relief from double taxation is granted by the state of residence
- Key term “in accordance with provisions of tax treaty”
- Methods for elimination of double taxation
 - Exemption method (Article 23A)
 - Credit method (Article 23B)
- Numerical examples in OECD MC Commentary illustrating each of the methods for elimination of double taxation

Articles in OECD MC

Non-discrimination

Article 24 of OECD MC

- The terms discrimination or non-discrimination is not defined
- Article 24 prohibits discrimination against foreign nationals and non-residents in the following cases:
 - On the basis of nationality (Article 24.1)
 - Against non-residents carrying on business through PE (Article 24.3)
 - Allow countries to allow the deduction of amounts paid by residents of a state to residents of the treaty partner on the same basis as amounts paid to residents of the first state (Article 24.4)
 - Corporations, partnerships and other entities resident of a state, whose capital is owned or controlled by residents of the other state, must be treated no less favourably than domestically owned or controlled enterprises (Article 24.5)

Articles in OECD MC

Mutual agreement procedure

Article 25 of OECD MC

- Mutual agreement procedure between the competent authorities in the two contracting states on treaty matters
- Following issues are sought to be resolved:
 - Disputes affecting a taxpayer resident in a contracting state due to taxation which is or likely to be inconsistent with the treaty provisions (Article 25.1 and 25.2)
 - Difficulties relating to the interpretation or application of the tax treaty (Article 25.3)
 - Elimination of double taxation in cases not provided for in the tax treaty (Article 25.3)

Articles in OECD MC

Exchange of information

Article 26 of OECD MC

- Exchange of information between the tax authorities of the contracting states

Select concepts in international taxation

Select concepts in international taxation

Brief discussion

- Triangular cases
- Partnerships
- Beneficial ownership
- Place of Effective Management (PoEM)
- Specific Anti-Avoidance Rules (SAAR)
- General Anti-Avoidance Rules (GAAR)
- Transfer pricing
- Thin capitalisation
- Controlled Foreign Companies (CFC)

Deloitte Haskins & Sells LLP

This material has been prepared by Deloitte Haskins & Sells LLP (DHS LLP) and contains general information only. This information is not intended to constitute professional advice or services or is to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser. The information contained in this material is intended solely for you thereby, any disclosure, copy or further distribution of this material or the contents thereof may be unlawful and is strictly prohibited.

None of DHS LLP or its affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this material.

© 2015 Deloitte Haskins & Sells LLP