

Introduction to  
International  
Tax Policy,  
Concepts and  
Principles

# Content

- Introduction to tax treaties
- Model Tax Conventions
- Overview of the Tax Treaty
- Interpretation of Tax Treaties
- Basic concepts
- Aids to interpretation
- Relevant Sections under the Act
- Practical Issues in Issuing CA Certificate
- Summary and Key takeaways

# Background

- 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’)

# Introduction To Tax Treaties

# What are tax treaties

- Tax Treaties are agreements entered into between countries with respect to taxes on income and on capital, wherein the countries agree to :
  - Be restricted from taxing
  - Provide relief for taxes paid in the other treaty country
- Types of Treaties
  - Bilateral ( between two countries)
  - Multilateral ( Between 3 or more countries)
- Treaties can be limited or comprehensive

# Why are tax treaties required



Promotion of cross border trade through elimination of double taxation



Providing clarity of fiscal situation of a taxpayer



Exchange of information to combat tax avoidance/tax evasion



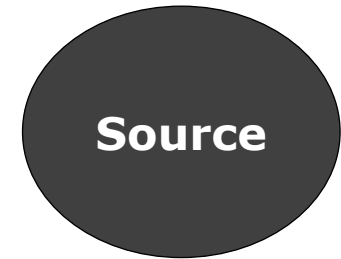
Sharing of tax revenues



Allow easy transfer of technology

# Concept

- Basis for levying income-tax
- Residence - Connects to Assessee
- Source - Connects to Income

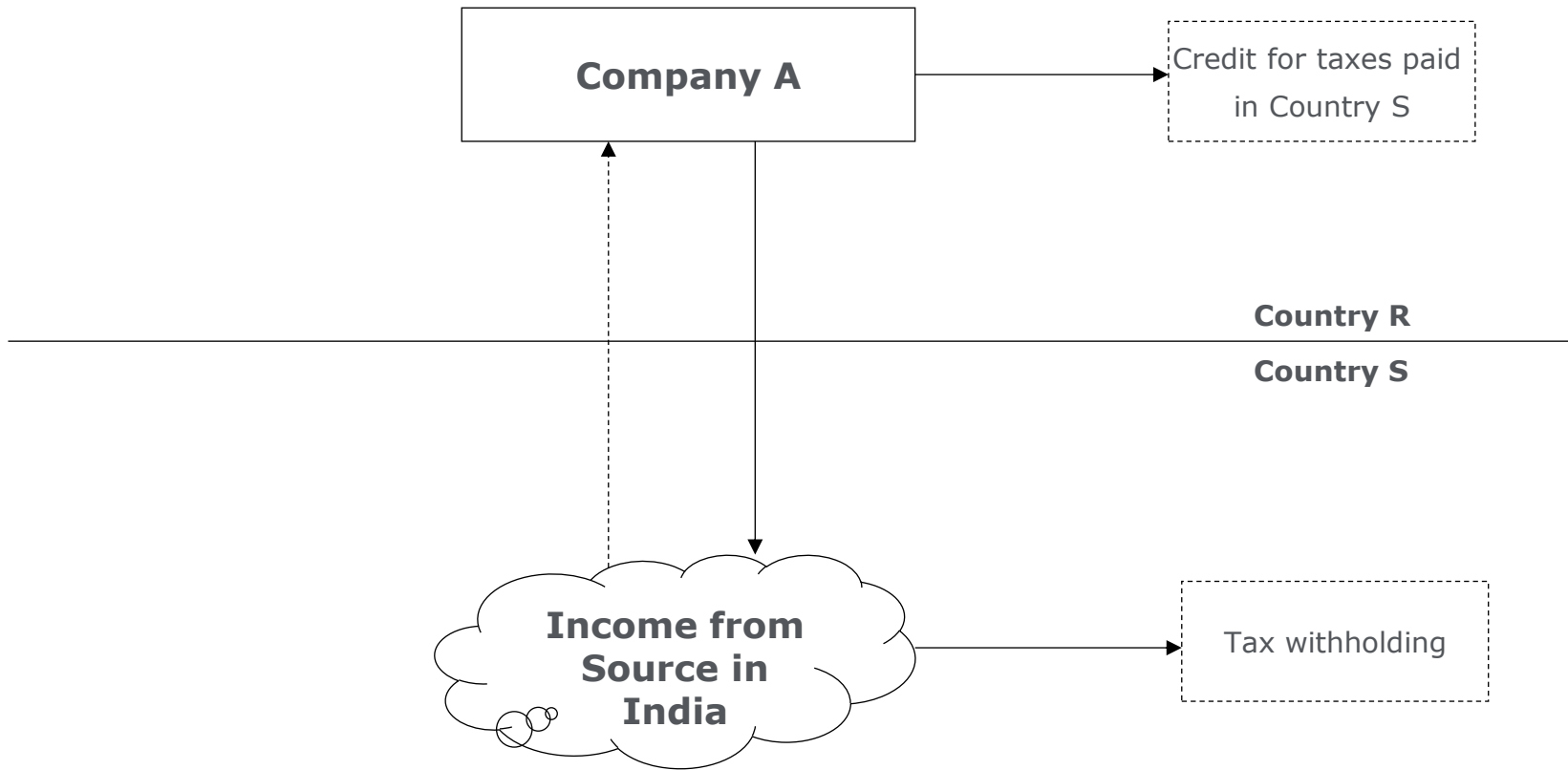


## Basic Principles of tax treaty

- State R (Resident) has basic rights to tax global income of its Resident
- State S (Source) shall also levy tax, however, generally lower than normal tax
- State S (Source) does not give credit for taxes paid in State R



# Basic Principles...



# First Principles

## Tax Treaty is a “Distributive Rule”

- Distinct from a taxing statute
- Cannot tax an item, which is otherwise not taxable
- Cannot tax an item at a higher rate

## Model Tax Treaties

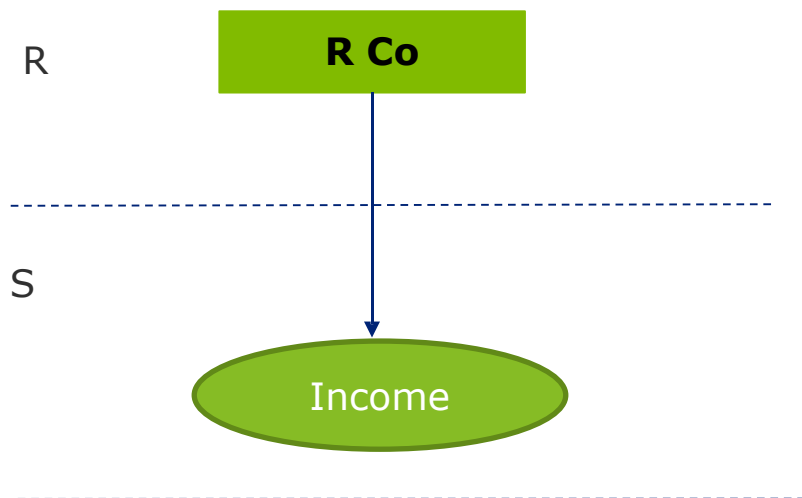
- OECD Model
- UN Model
- US Model

## Vienna Convention

- General Principles for interpretation of international agreements

# Juridical Vs Economic Double Taxation

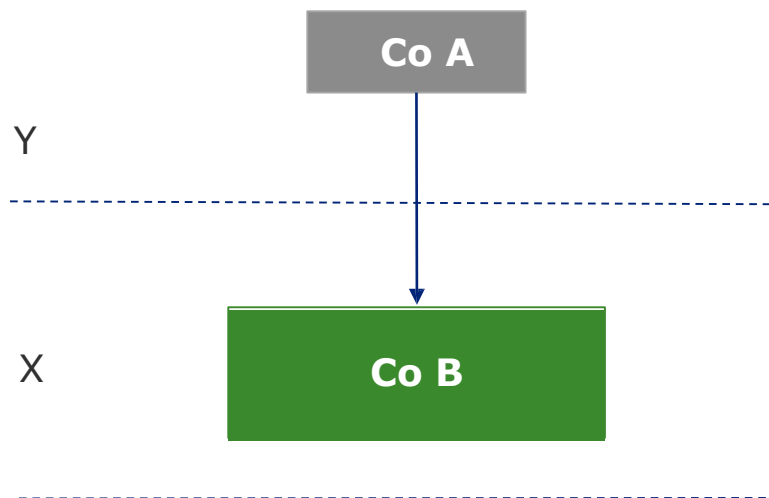
## Juridical Double taxation



Income is subject to tax in two countries  
-Shared taxing rights

Ex: FTS/Royalty

## Economic Double Taxation



Two legal entities are subject to tax on same  
Income in two countries -

Ex: Unilateral Transfer Pricing adjustment

# Legal Effect of Tax Treaty

- Applicability of Treaty is conditional to the applicability of the Act. Treaties do not impose taxation since they are not given the function of being tax instruments
  - Scope of Section 5 and Section 9 needs to be examined -- if income liable to tax in India relevant Treaty is applicable
- Taxation is always based on domestic tax law. Treaties do not impose taxation
  - Section 90(2) provides:  
“ . . . . 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”
- Treaty does not automatically have precedence, but domestic tax laws say so
  - CBDT issued Circular 333 -- specific provisions of the tax treaty override general provisions of the Act, of importance prior to introduction of Section 90

# Treaty Override

- Treaty are given effect by domestic legislations therefore domestic law can provide exceptions
  - Section 90 provides Article 24 –Non-discrimination is not applicable on tax rates
  - Special taxes not covered under Article 2
    - UK – Diverted Profits tax
    - India – Dividend Distribution Tax ; Buyback Tax
  - Anti – Avoidance Rules
    - Domestic – General Anti Avoidance Rules
    - Tax Treaty – Limitation of Benefits (India Singapore Tax Treaty)

# Tax treaty – Basic aspects

- Structure of a DTAA
  - Scope & definitions
  - Distribution rules - COS
  - Elimination of double taxation by COR
  - Special provisions
  - Final provisions - Entry into force & Termination
  - Protocols and Memorandum of Understandings

## Tax Treaty – whether applicable?

- Residential status
- Taxes covered
- Persons covered

## Tax treaty – Do not forget!

- Protocols and Memorandum of Understandings
- MFN clause
- LOB clause



## Some practical aspects

- Cost benefit analysis
  - credit in the home country against tax paid in India
- Complex legal structures – Unresolved issues
  - LLPs / Partnerships
- Law is always trying to catch up to business
  - E.g. - E-commerce
- Approach of the Income-tax Department
- Tax structuring to be in alignment with other business objectives

# Model Tax Conventions

# Model Tax Conventions

## 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
- Advocates residence principle
- Lays emphasis on right of state of residence to tax

## UN Model

- Tax treaties between 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
- Most of India's tax treaties are based on this model

# Model Tax Conventions

## Other Models

- US Model - Only model which USA uses as a basis of negotiating treaties with its other treaty partners
- ANDEAN Model - Drawn up by Latin American countries (Bolivia, Chile, Columbia, Ecuador, Peru & Venezuela)

## Relevance of Model Conventions

- Aids negotiation of tax treaties
- To makes treaties uniform
- Aids in interpretation

# Model Tax Conventions

OECD & India

---

**2001** - Member of technical advisory group on E-commerce Tax Treaty Characterization issues

---

**July, 2006** – Granted ‘OBSERVER’ status

---

**May, 2007**- Offered enhanced engagement with a view to possible membership

---

**July, 2008** - India’s position included in the non-member country positions section of the 2008 update

---

## Used by Courts/Tribunals

The Courts/Tribunals have placed extensive reliance on OECD Commentary while interpreting tax treaties:

- Morgan Stanley – Supreme Court
- Set Satellite – Mumbai ITAT
- Galileo International Inc. – Delhi ITAT

# Overview of Tax Treaty

# Overview of Tax Treaty – Articles of Treaty

## Scope Provisions

Article 1 : Personal Scope  
Article 2 : Taxes Covered  
Article 29: Entry into force  
Article 30: Termination

## Definition Provisions

Article 3: General Definitions  
  
Article 4: Residence  
  
Article 5: Permanent Establishment

## Substantive Provisions

Article 6 : Immovable Property  
Article 7 : Business Profits  
Article 8: Shipping, etc.  
Article 10: Dividend  
Article 11: Interest  
Article 12: Royalty & FTS  
Article 13: Capital Gains  
Article 14: Independent Personal Services  
Article 15: Dependent Personal Services  
Article 16: Directors  
Article 17: Artists & Sports persons  
Article 18: Pensions  
Article 19: Government Service  
Article 20: Students  
Article 21: Other Income  
Article 22: Capital

## Elimination of double taxation

Article 23 : Elimination of double taxation  
Article 25: Mutual agreement

## Anti - avoidance

Article 9: Associated Enterprise  
Article 26: Exchange of Information

## Miscellaneous Provisions

Article 24: Non -Discrimination  
Article 27: Diplomats  
Article 28: Territorial Extension

# Stages in Life of a Tax Treaty

- Entry into Force
  - Date of Convention
  - Date of Ratification
  - Date of Notification
  - Date of Entry into Force
  - Effective Date
- Exchange of Notes, Protocols, MoUs, etc.
- Termination (Generally followed by a revised Treaty)



# Protocol, Exchange of Notes and Memorandum

- Such documents elaborate and complete the text of the DTAA
- Legally they are a part of the treaty and their binding force is equal to that of the principal treaty text.
- Generally explanatory in nature
  - Memorandum – Indo-US treaty - explains provisions with illustration
- Can also bring substantive provision
- 'Most Favoured Nation' Clause – Generally contained in the protocol to a DTAA

# Accessing a Tax Treaty

## Step 1

- Whether income earned from home country or source country?

## Step 2

- Whether resident of at least one of the two contracting states?

## Step 3

- Characterisation of Income
- Application of Distribution Rule
- Consideration of domestic tax laws

## Step 4

- Taxation / Exemption in source country
- Limitation of Benefits Clause

## Step 5

- Tax Credit in home country

# Interpretation of Tax Treaties

# General Principles of Interpretation

- Text of the DTAA is of primary importance
- Also wording of individual provision not to be read in isolation, but that of entire agreement and the context to be considered
- Reasonableness and consistency
- Principle of effectiveness
- Principles of Interpretation as found in judicial decisions
  - Purposive/liberal interpretation instead of “strict” or “literal” interpretation
    - Objective of tax treaty to be considered – UOI v. Azadi Bachao Andolan 263 ITR 706 (SC)

# International Law - Vienna Convention

## General Principles for interpretation of international agreements – Vienna Convention

- **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 light of its object and purpose

- **3 main schools of thought**

- Textual / ordinary meaning of the words
- Intention of the parties / founding fathers
- Aims and objects

- The principals of these 3 schools are not necessarily exclusive of one another. Subordinate of each other

- **Article 31**

31(2) Context is defined to include in addition to text, its preamble and annexure:

- Agreement in connection with conclusion of treaty
- Instrument made by one and accepted by another

- **31(3) together with text**

- Subsequent agreement
- Subsequent practice
- Relevant rules of international law
- Special meaning – only if intended by parties

# Vienna Convention

- **Article 32**

Supplementary means of interpretation, including preparatory work of treaty and circumstances of its conclusion when meaning accordingly to Article 31

- Ambiguous or obscure
- Manifestly absurd or unreasonable

- **Article 33**

- Treaty authenticated in more than one language – the text is equally authoritative in each language
- Treaty provides that any other version (say, English) is authentic
- When two authentic texts disclose a different meaning – meaning which best reconciles with text

# Basic concepts

# Concept of PE

**PE**

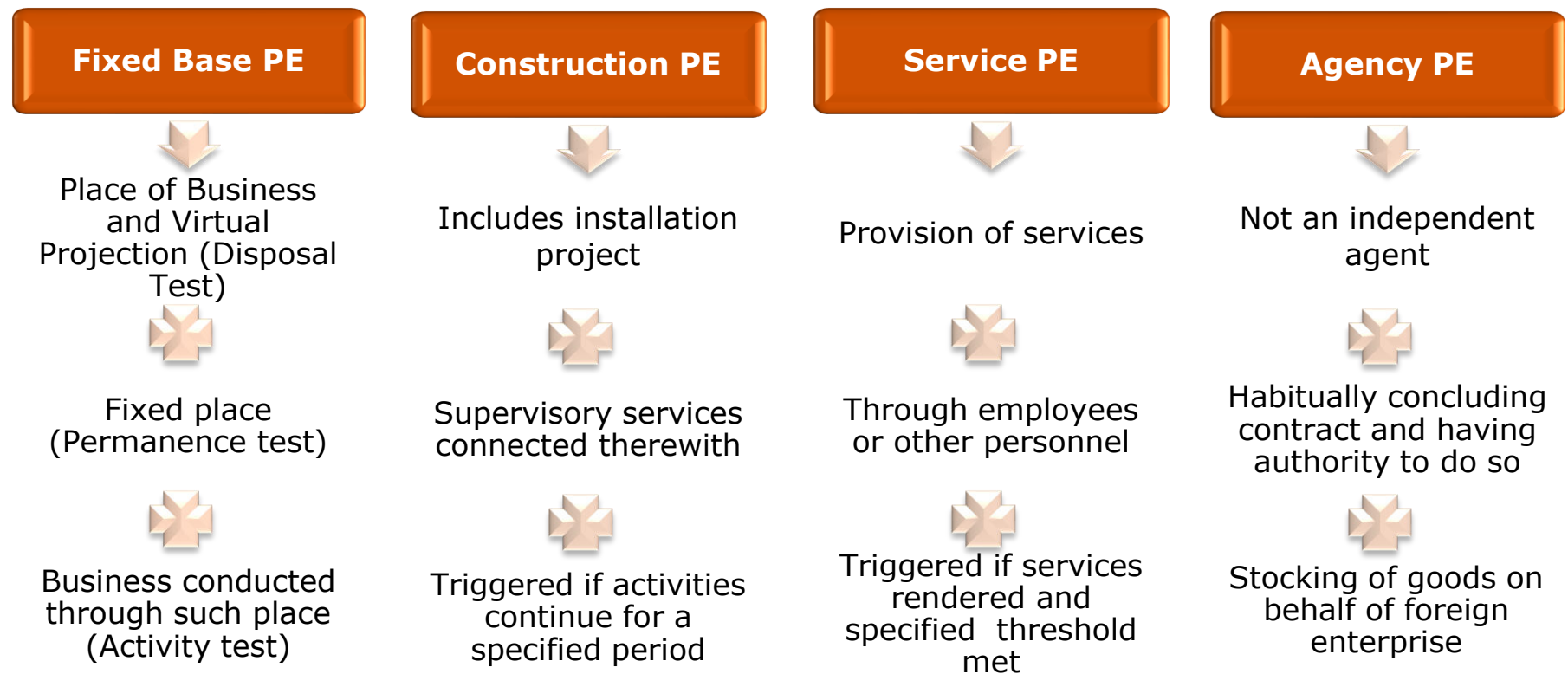
Artificial entity created for taxing the income of a non-resident from business operations carried out by it in India

When the activities conducted in India exceeds the specified number of days prescribed in the relevant DTAA, a PE is constituted

Constitution of the PE in India bestows Indian Revenue authorities the right to tax income of the non-resident attributable to PE activities in India



# Types / Categories of PE



## 'force of attraction' rule – IBFD International tax glossary

- “Principle under which a country may tax a foreign enterprise in respect of income it derives in that country if the enterprise maintains a permanent establishment there, irrespective of whether that income is derived through or otherwise economically connection with the permanent establishment.....”

# Force of Attraction Rule

- Article 7 Para 1 of the UN Model Convention.

“The profits of an enterprise of a Contracting State shall be taxable only in that State unless the ..... may be taxed in the other State but only so much of them as is attributable to

(a) that permanent establishment;

(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or

(c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.”

- The Article reproduces Article 7 para1 of the OECD – Model Convention, with the addition of clauses (b) and (c).

**‘Force of attraction’ rule not present in OECD Model Convention**

## Rationale for Force of Attraction rule in UN model

- UN Model is a compromise between taxation in the state of residence and taxation in the state of source. However, it attaches more significance on source state taxation.

Extended Source Taxation in UN Model can be shown by the following differences between OECD MC and UN MC



Article 5(3) - Extended PE Definition



Article 14(1) - Independent Personal Services clause



Article 7(1) - Force of Attraction Rule – Business profits clause

## MFN status – IBFD International tax glossary

- “Trade agreements between two countries may contain a ‘most-favoured nation’ clause under which each party agrees that any trade concession given to other trading partners will also be applied to the other party to the agreement, i.e. more favourable terms will not be granted to other countries without granting the same concessions to the treaty partner.....”

# MFN status

- Normally benefit under the MFN clause is restricted to a specific group (for instance, OECD countries)
- Nature of benefit:
  - Lower tax rate
  - Narrowing scope of income liable to tax
  - Allowing higher deduction (for instance, general admin expenses)
- Generally, MFN status provided under the protocol / exchange of notes
- At times, CBDT issues notification in respect of MFN status
  - However, this is generally clarificatory (with exceptions. For eg. India-Switzerland Treaty)

# Beneficial ownership

- The “first line of defence” against treaty shopping
- Used in Arts. 10, 11 & 12
- Not defined in most treaties
- No direct precedents in India
- AAR Rulings
  - Where sole objective is to avail treaty benefits - treaty benefits denied (Natwest Ruling)
  - Where several other considerations weigh along with treaty benefits – treaty benefits cannot be denied (AIG Ruling)
- CBDT Circular
  - Tax Certificate proof of beneficial ownership for Mauritius Treaty
- SC in Azadi Bachao Andalon case
  - Upholding treaty shopping unless restricted by a LOB Clause in the treaty

# Aids to interpretation



# Aids to Interpretation

- Reference to domestic law under Article 3(2)
- Indian judicial decisions
- OECD/UN commentary
  - Whether binding?
  - Static vs. Ambulatory approach
  - India positions – Revised OECD commentary in 2008
- Parallel treaties
- Other aids to interpretation
  - Relevance of treaty negotiation materials, technical explanations, etc.
  - Relevance of foreign judgments
  - Protocol, exchange of notes & memorandum

## Reference to domestic law

- **Article 3(2) of OECD MC**

“As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State”

- CIT v. P.V.A.L. Kulandagan Chettiar 267 ITR 654 (SC) – Meaning can be ascertained from the domestic tax law where the term is not defined in the DTAA
- Section 90(3) – Notification issued by Government to be used if any term not defined under the Act or the DTAA, unless the context otherwise requires

# Reliance on Commentaries – OECD / UN Commentary

## **OECD Commentary 2005**

- Recommendatory in nature ... Para 3 – Introduction to OECD Commentary
- “Worldwide recognition of provisions of MC and their incorporation into majority of conventions have helped make Commentaries a widely accepted guide to interpretation”  
... Para 15 – Introduction to OECD Commentary

## **UN Commentary**

- Not enforceable and not binding..... Para 35 Introduction to UN Commentary
- “If negotiating parties decide to use in a treaty, wording suggested in UN MC, it is presumed that they would also expect to derive assistance in interpretation of that wording” ... Para 36 of UN Commentary

## Reliance on Commentaries – Judicial view

- Where Tax Treaty is similar to model convention – commentaries thereon provide useful guides
  - UOI v. Azadi Bachao Andolan 263 ITR 706 (SC)
  - CIT v. Vishakhapatnam Port Trust 144 ITR 146 (AP)
  - Motorola Inc (Del SB) (95 ITD 269)
  - Metchem Canada Inc (Mum Trib) (100 ITD 251)
- In certain cases, judiciary refused to follow the OECD commentary
  - P. No. 28 of 1999, 242 ITR 208 (AAR)
  - CIT v. P.V.A.L. Kulandagan Chettiar 267 ITR 654 (SC)
- In some cases, the observations of Court give an impression that reliance upon OECD Commentary is 'inappropriate'
  - CIT v. S.R.M. Firm & Others 208 ITR 400 (Mad)
  - SNC Lavalin / Acres Inc v. ACIT 15 SOT 1 (Delhi ITAT)

# Reliance on Commentaries

## **Conclusion**

- Both tax payers/tax authorities have been liberally referring to the OECD/UN MC and Commentary to support their respective claims
- Courts have generally accepted them as an important aid for interpretation of tax treaties

# Static v. Ambulatory approach to Interpretation

## **Static Approach – Domestic Law definition on the day on which the Tax Treaty is concluded**

- Siemens Aktiengesellschaft v. ITO 22 ITD 87 (Mumbai ITAT) - Static interpretation; change in incorporating statute not to have effect on incorporated statute, artificial definition not applicable
- Melford Developments Inc – Canadian Supreme Court – Change in domestic law is so radical that it widens tax net far beyond what could be a reasonable contemplation of parties. Such radical change if permitted would lead to unilateral amendment to Tax Treaty

## **Ambulatory Approach – Changes made in the definition also to be considered – i.e. definition on the day on which the Tax Treaty is being applied**

- OECD commentary – “at any time” specifically inserted in MC – Ambulatory approach – Article 3(2) – Para 11 of Commentary on Article 3
- ITO v. Leonhardt Andra UND Partner 21 ITD 607 (Calcutta ITAT) – Ambulatory interpretation
- P. No. 30 of 1999, In re 238 ITR 296 (AAR) - A useful reference can be made to the revised OECD commentary while interpreting a previously concluded DTAA
- Similar view followed in Amex Ruling (AAR) (238 ITR 296)
- As per David A. Ward – Existing commentary at the time of signing treaty should apply

## Parallel treaty

- Philip Baker in his treatise 'Double Taxation Convention' has stated in following words:  
"There is no reason why parallel treaties should not be referred to, but, their value as aids to interpretation will generally be low"
- Inference should be drawn only with extreme caution ... Klaus Vogel
- Supreme Court (in Azadi Bachao Andolan) has relied upon Indo-US DTAA ("Limitation of Benefits Clause") while deciding on treaty shopping

## Other Aids to Interpretation

- Relevance of treaty negotiation materials
- Relevance of unilateral material such as technical explanations, private letter rulings etc. for interpretation of treaties
- OECD Reports can be relied –
  - Sonata Info. Tech. Ltd. v. ACIT 103 ITD 324 (Bangalore ITAT)
  - DDIT v. SET Satellite (Singapore) Pte. Ltd. 106 ITD 175 (Mumbai ITAT)
- Are such documents publicly available?
- Relevance of foreign judgments

*"harmonisation of these conventions in accordance with uniform principles, definition, rules and methods, and agreement on a common interpretation, become increasingly desirable"* (Introduction to OECD MC)
- Not legally binding although useful reference for common interpretation
- Trend in India – even for typical domestic law interpretation issues reference is made to parallel treaties and foreign judgments
  - CIT v. Vishakhapatnam Port Trust 144 ITR 146 (AP)
  - CIT v. P.V.A.L. Kulandagan Chettiar 267 ITR 654 (SC)



## India Positions – Revised OECD Commentary in 2008

- India provided its position on OECD Commentary, in capacity of an observer
  - MoF formed a Committee of revenue officers to finalise the comments
  - Final comments approved by MoF, before submission to OECD
- India's position consists of:
  - Matters, where India does not agree with the interpretation of OECD
  - Matters, where India has reserved its views
  - Matters, where India would reserve the right to amend the Treaty wordings
- Binding nature of India comments
  - No legislative backing – comments of Government as distinct from Parliament
  - At the most, India comments can only have a persuasive value
    - Practically, Tax Officers would tend to follow India position, when favourable to revenue

**What happens on matters, where India has not expressed a position and the OECD view is favourable to the taxpayer?**

# Relevant Sections under the Act

# Important Provisions under the Act

- Indian Context – Authority to enter into Tax Treaties
  - List I of 7th Schedule to Constitution of India
  - Section 90 of the IT Act
- Fundamental Rule
  - “Beneficial provisions shall apply”
  - Section 90(2) & Circular No. 333 dated April 2, '82
- Unilateral Tax Credit u/s 91

# Relevant Sections

Sec. 2 (31)	-	Definition of a Person.
Sec. 2 (7)	-	Definition of an Assessee.
Sec. 6	-	Conditions of Residence.
Sec. 5	-	Scope of Total Income.
Sec. 9	-	Income deemed to accrue or arise in India.
Sec. 4	-	Charge of Income-tax.
Sec. 90	-	Agreement with Foreign Countries.
Sec. 91	-	Countries with which no agreement exists.
Sec. 92	-	Computation of income from international transaction having regard to arms length price.
Sec. 92A	-	Meaning of Associated Enterprise.

Sec. 92 B	-	Meaning of International Transaction.
Sec. 92C	-	Computation of Arms Length Price.
Sec. 92D	-	Reference to Transfer Pricing Officer.
Sec. 93	-	Avoidance of income-tax by transactions resulting in transfer of income to non-residents.
Sec. 195	-	Tax withholding for payment made to non-residents
Secs. 115 A-F	-	Provisions relating to non-residents.

# Practical Issues in Issuing CA Certificate

## Practical issues

- Examination of relevant records and books of accounts
  - What if there are no books of accounts in India of the non-resident?
- Applicability of relevant Tax Treaty
  - Tax Residency certificate from the non-resident
    - Whether sufficient evidence for eligibility of the non-resident to Tax Treaty benefits?
- Characterization issues – whether royalty, FTS, etc.

## Practical issues

- Verification of PE in India
- Determining whether payments attributable to a PE in India?
- Management Representation Letter from the payer
  - Whether a similar representation required from the payee?
  - Issues such as number of days of stay of the payee in India
- Whether certificate can be issued when the payer does not have a complete information about the payee?
  - Can a NIL foreign remittance certificate be issued?

# Documentation

- Agreement
- Invoice
- Tax Residency Certificate
- Letter of Representation
- File Note
- Payment details
- Undertaking



# Summary and Key takeaways

# Applying Tax Treaties

- Step 1 – What is the nature of the income?
- Step 2 – Does the treaty apply?
- Step 3 – Determine which article applies?
- Step 4 – How are taxing rights assigned?
- Step 5 – How is the income calculated?

## Key Take Aways

- Cross border transactions on an increasing trend
- Even small companies – Keen in having cross border transactions
- International Tax Issues are knocking at the door of the practicing Chartered Accountant
- Tax Treaties is an extension of tax laws
- Proposed Direct taxes code gives importance to international tax issues
- International Tax - no longer an emerging area - “an imminent area” of practice

# Questions

