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# Tax Conventions – History, Overview & Basics of DTAA

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WIRC – Seminar on International Taxation for  
Beginners

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# Content

- Introduction to tax treaties
- Model Tax Conventions
- Overview of the Tax Treaty
- Steps When Referring to Tax Treaties
- Practical guidance





# Introduction To Tax Treaties



# 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

# Introduction to Tax Treaties

## Why are tax treaties



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

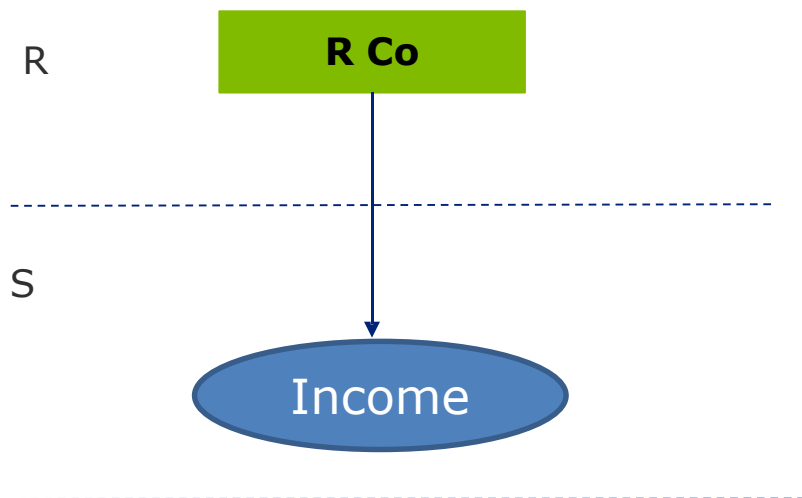


Allow easy transfer of technology

# Introduction to Tax Treaties

## Juridical Vs Economic Double Taxation

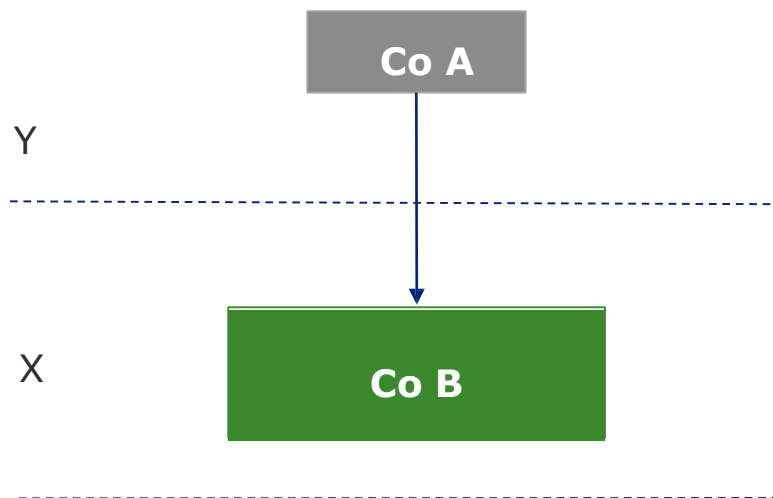
### Juridical Double taxation



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

# Introduction to Tax Treaties

## 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

# Introduction to Tax Treaties

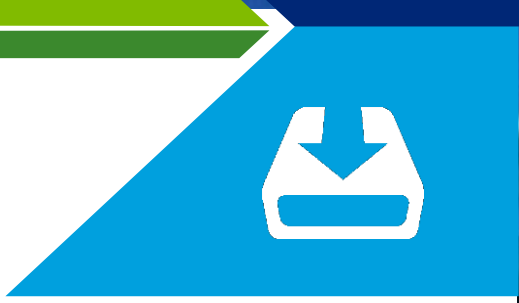
## Treaty Override

- 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)*





# 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

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

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July, 2006 – Granted ‘OBSERVER’ status

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

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

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## 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

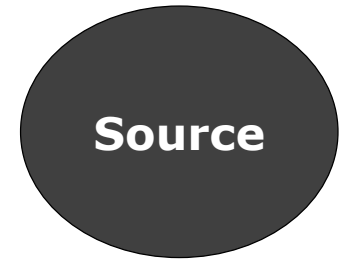
## Miscellaneous Provisions

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

# Concept and Basic Principles

# Concept

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

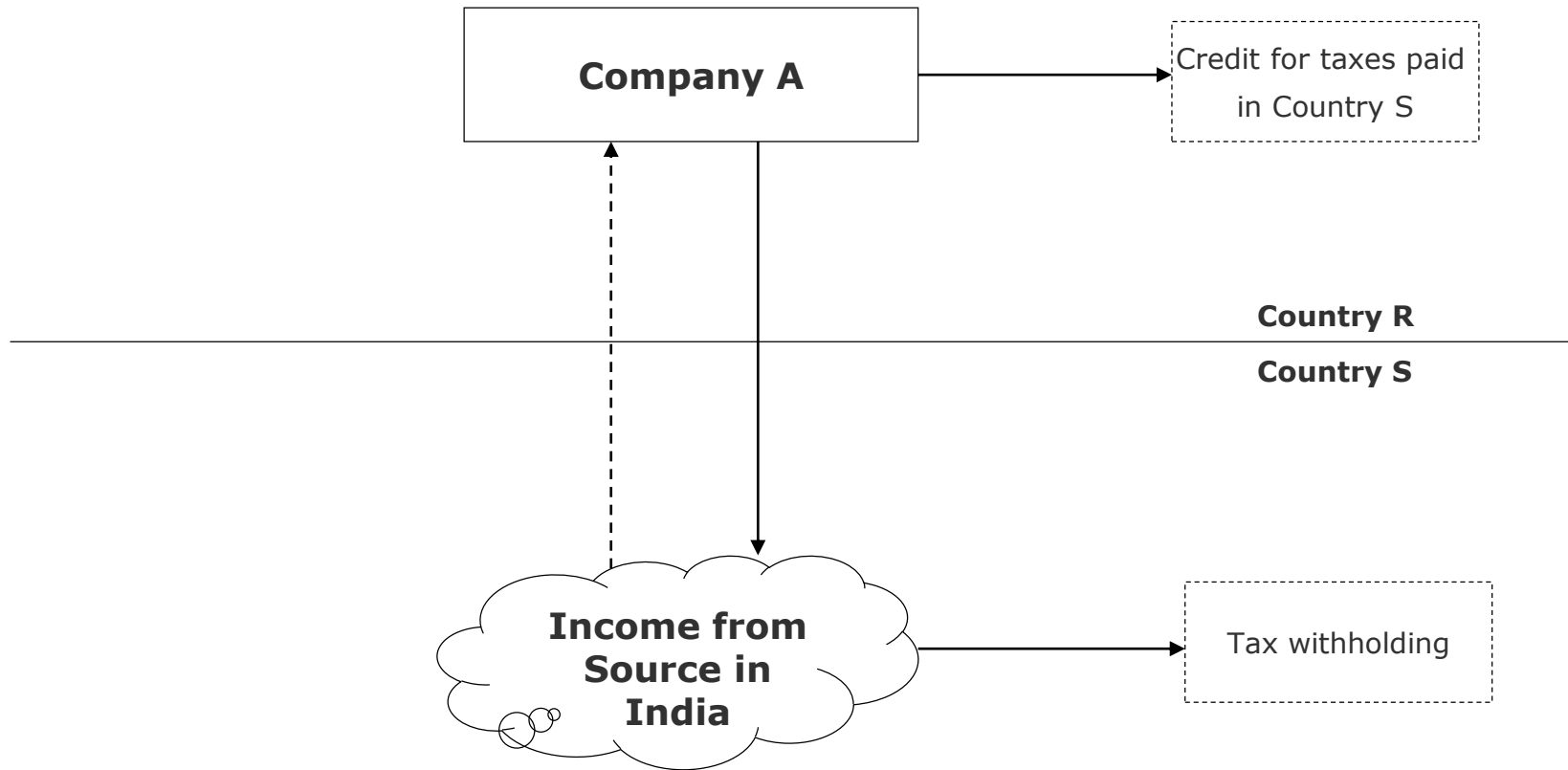




# Basic Principles of tax treaty

- 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...



# ...Basic Principles

- Tax Treaty is a “Distributive Rule”
  - Distinct from a taxing statute
  - Can a treaty impose higher tax burden than under the domestic law?
    - 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

# 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.

# Overview

Articles covered	Category	Subject matter
1, 2, 29 & 30	Scope	Taxes covered / To whom it applies / Entry into force / Termination
3, 4 & 5	Definition	General / Resident / Permanent Establishment
6 to 22 (except Article 9)	Substantive Provisions	Articles dealing with various incomes – business profits, shipping & aircraft income, dividends, interest, royalties, fees for technical services, capital gains, salary income, pensions, etc.
23A, 23B & 25	Elimination of Double Taxation	Exemption method vis-à-vis credit method / Mutual Agreement Procedure
9 & 26	Anti-Avoidance	Exchange of information, Limitation of Benefits
24, 27 & 28	Miscellaneous	Non-discrimination, Most Favoured Nation clause

# 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)



# 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

# 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



## Article 2



# Article 2

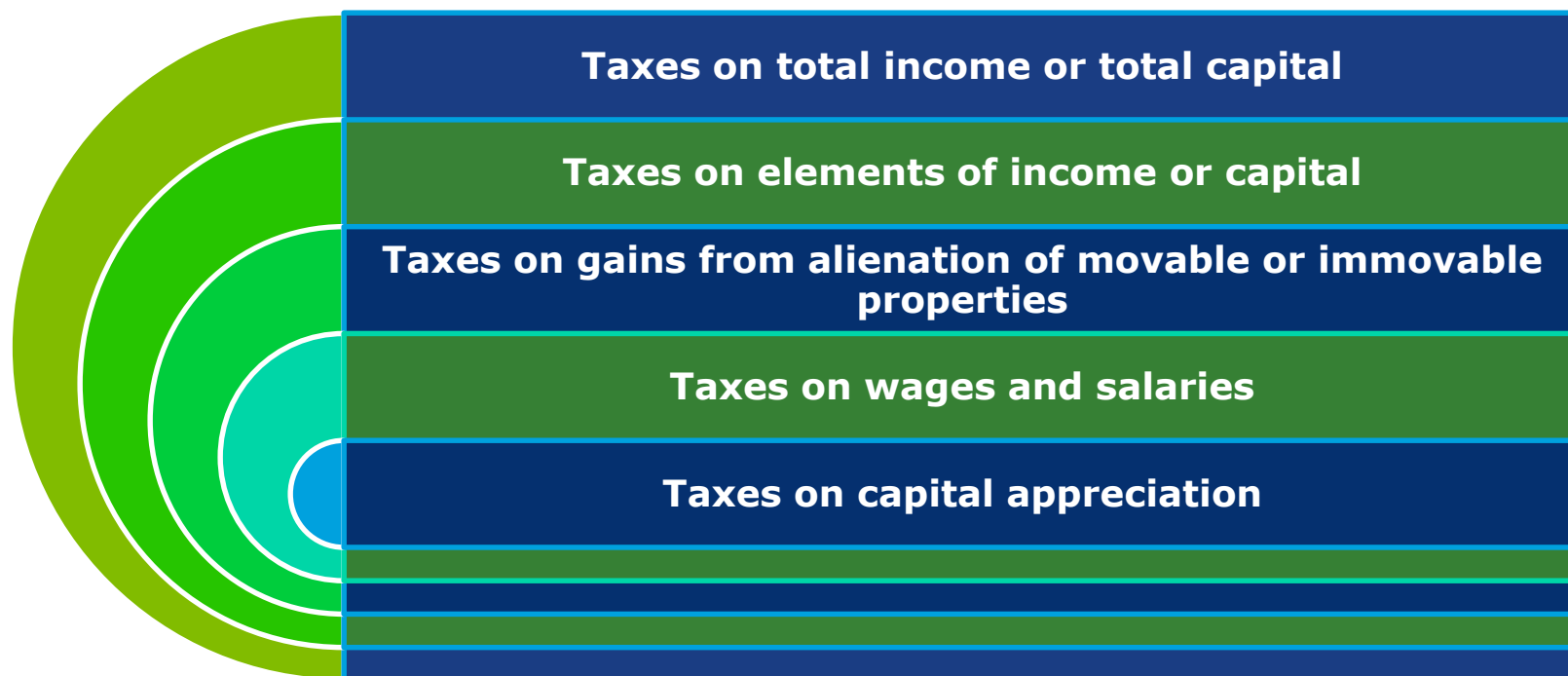
## Taxes Covered - Scope of the Convention

- “This convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or its political subdivisions or local authorities, irrespective of the manner in which they are levied.”
- Applicable to all taxes -
  - On income and capital;
  - Imposed by contracting state; and
  - Irrespective of manner of levy
- “taxes on income” vis-à-vis “direct taxes”
- Are indirect taxes covered?
- Are future taxes covered?
- Practically –
  - Most tax treaties defines specific taxes which are covered
  - Generally, indirect taxes are excluded
  - Interests and penalties are not included

# Article 2

## Art 2(2) – Definition of Taxes

- “There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.” - OECD and UN Model are identically worded



# Article 2

## Art 2(2) – Definition of Taxes – Indian Perspective

Interest and Penalty

Surcharge and  
Education Cess

Dividend  
distribution tax /  
buyback tax?

Property tax /  
Wealth tax?

Social security  
charges?

Equalization levy?

# Article 2

## Art 2(2) – Future Taxes

- “The convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of existing taxes. The competent authorities of the contracting states shall notify each other of any significant changes that have been made in their taxation laws.”
- Intent – no need to amend the treaty in case one of the treaty country amends its domestic law with identical or substantially similar taxes in addition to, or in place of an existing treaty
- Identical or substantially similar taxes
  - Essential Characteristics of tax – Basis – Computation method – tax payers
  - Education Cess – similar to surcharge
- Undertake to notify or communicate any significant changes – no time limit has been prescribed



# Article 3





# Article 3

## Definitions

- OECD / UN / US Model have Article 3 as definition section
- Article 3(1) : Defined terms
- Terms defined
  - Person
  - Company
  - Enterprise
  - Enterprise of a Contracting State and the Enterprise of the other Contracting State
  - International traffic
  - Competent Authority
  - National
  - Business
- Article 3(2) : Undefined terms

Definitions in Article 3 apply unless the context otherwise requires

# Article 3

## Definitions

- Applicable throughout the conventions
- Separate Articles, such as
  - Article 4 - Resident
  - Article 5 - Permanent establishment
  - Article 6 - Immovable property
  - Article 10 - Dividends
  - Article 11 - Interest
  - Article 12 - Royalties
- Treaties also contain additional definitions – ‘tax’, ‘fiscal year’, ‘India’

# Article 3

## Person

### **Article 3 – General definitions**

*" 1. For the purpose of this Convention, unless the context otherwise requires:*

*(a) the term "person" includes an individual, a company and any other body of persons;"*

- Partnership as person
  - Defined as Company
  - OR
  - Constitute other bodies of persons

# Article 3

## International Traffic

### General definitions

*" 1. For the purpose of this Convention, unless the context otherwise requires:*

*(e) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;"*

### Interpretation

- Relevance under Article 8
- Article 8 deals with profits from operation of ships or aircrafts in international traffic, taxable in Contracting State in which the place of effective management (POEM) of the enterprise is situated.

# Article 3

## Art 3(2) – Undefined terms

- *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 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.*

### **Rules in Article 3(2):**

- ....unless the context otherwise requires....”
- Domestic tax law meaning vs. domestic general law meaning
- Ambulatory vs. Static

# Article 3

## Art 3(2) – Undefined terms

### **The context is determined as under**

- Intention of the Contracting States when signing the Convention.
- Principle of reciprocity (i.e. meaning given to the term in question in the legislation of the other Contracting State).
- Satisfactory balance :
  - need to ensure the permanency of commitments entered into by states when signing a Convention
  - need to apply the Convention in a convenient and practical way over time.

# Article 3

## Art 3(2) – Static Vs Ambulatory Approach

	<b>Ambulatory Approach</b>	<b>Static Approach</b>
Meaning	Law in enforced when the Convention is applied	Law prevalent at the time when the Convention is signed

- OECD Convention refers the word “at any time..... at that time”

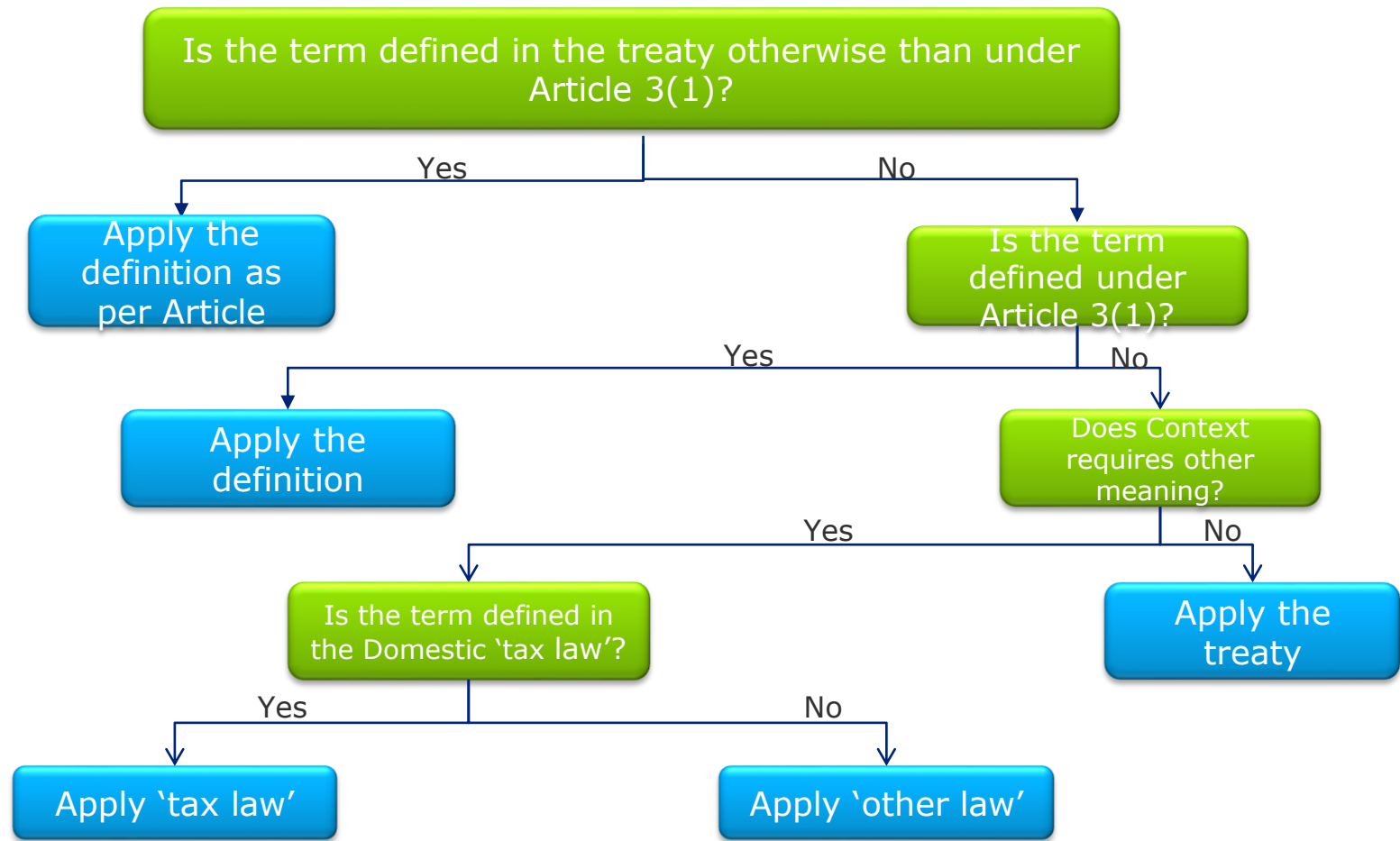
# Article 3

## Art 3(2) Vs Income tax Act

<b>Finance Act, 2003 w.e.f 1.4.2004 (A.Y. 2004-05 onwards)</b>	<b>Finance (No.2) Act, 2009 Substitution of Section 90 w.e.f 1.10.2009</b>	<b>Finance Act, 2012 Explanation 3 added w.e.f. 1.10.2009</b>
<p>Any term used but not defined in this Act or in the agreement referred to in sub-section (1) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the agreement, <i>have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.</i></p>	<p>Section 90(3) is same</p>	<p>For the removal of doubts, it is hereby declared that where any term is used in any agreement entered into under sub-section (1) and not defined under the said agreement or the Act, but is assigned a meaning to it in the notification issued under sub-section (3) and the notification issued thereunder being in force, then, the meaning assigned to such term <i>shall be deemed to have effect from the date on which the said agreement came into force.</i></p>



# Article 3 Summary



# Article 4 - Resident

- Resident of a Contracting State - any person who under the laws of that state is **liable to tax** therein by reason of his-
  - Domicile; or
  - Residence; or
  - Place of effective management; or
  - Any other criterion of a similar nature
- Some treaties refer to 'subject to tax'
  - Any difference between 'liable to tax' and 'subject to tax'?
- No person to be resident in a state merely by reason of having a source of income in that state - "Global Basis" Taxation in country of Residence

# Article 4 - Resident

- In case a person is resident in both contracting states, the tie-breaker rules apply:
  - Rule for Individual
    - ✓ Test 1: permanent home
    - ✓ Test 2: personal & economic interests
    - ✓ Test 3: habitual abode
    - ✓ Test 4: nationality
    - ✓ Last option: MAP
  - Rule for non-individuals
    - ✓ Place of 'effective management'
- Importance and relevance of 'Tax Residency Certificate'?
  - Whether conclusive evidence?

# Article 5 and 7 – Permanent Establishment / Business Profits

- Business Profits taxed in host country only to the extent of profits attributable to a PE
- Concept and Categories of PE
- Primary activities Vs. Preparatory / Auxiliary activities
  - Preparatory activities do not constitute a PE
- Concept of 'Force of Attraction'
- Profits of the PE computed by considering the PE:
  - As a 'distinct and independent' enterprise
  - Engaged in same or similar activities under same or similar conditions
  - Dealing wholly at arms length with the enterprise

# Concept of PE

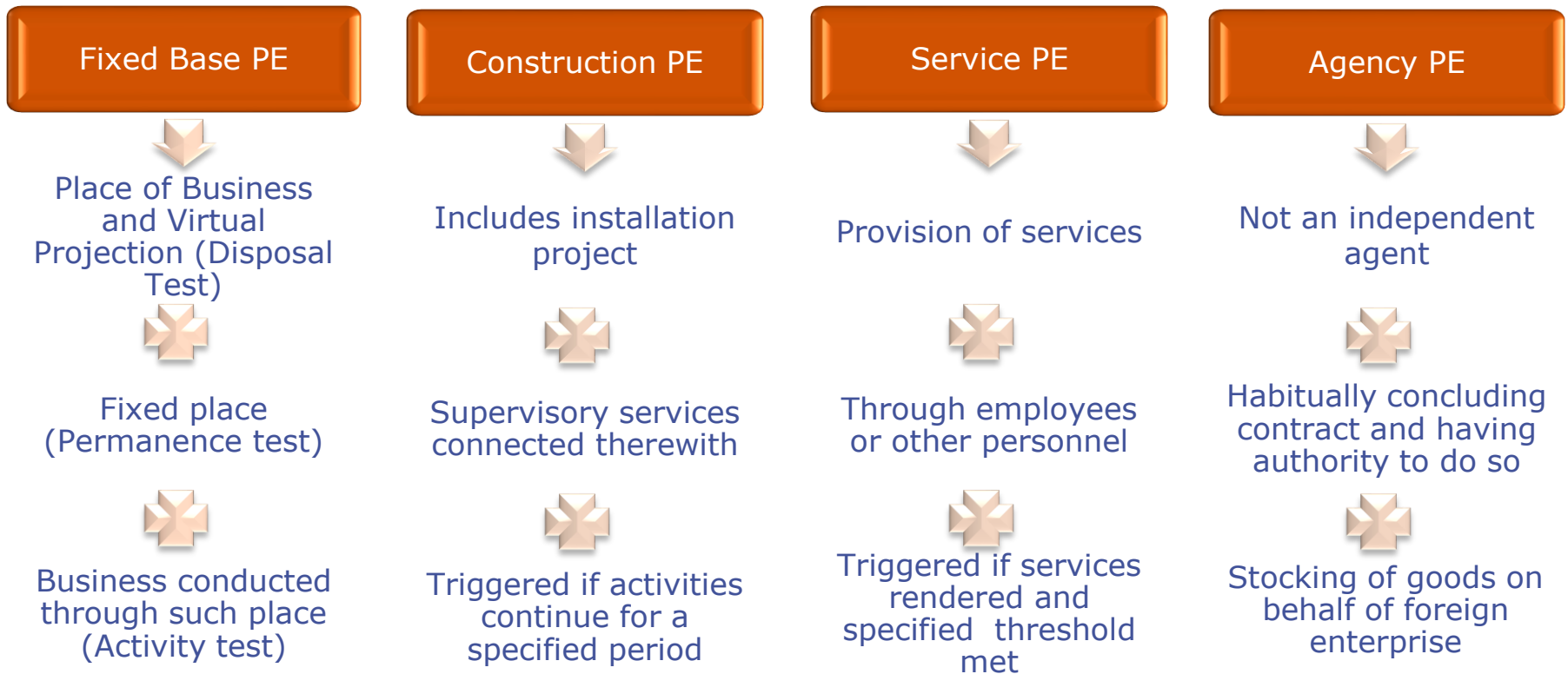
**PE**

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



# Article 10 and 11 – Dividend / Interest

- Source-based taxation
- Specific definition of 'Dividends' and 'Interest' under Tax Treaty
  - Dividend -“shares, participating in profits rights, other rights not being debt claims, etc.”
- Tax Treaty imposes a limitation on the maximum rate to be charged by the source country
  - Generally, the condition of “beneficial owner” exists
- Dividends / Interest earned if “effectively connected” with PE taxed under Article 7

# Article 12 – Royalty

- Source-based taxation
- Specific definition of 'Royalty' under Tax Treaty – consideration for:
  - Right to use, any copyright
  - Cinematograph films, films or tapes used for radio / TV
  - Patent, trademark, design, model, plan, secret formula, process
  - Right to use industrial, commercial or scientific equipment
  - Information concerning industrial, commercial or scientific experience
- Tax Treaty imposes a limitation on the maximum rate to be charged by the source country
  - Generally, the condition of “beneficial owner” exists
- Copyright Vs. copyrighted article
  - E.g.. payments for software



# Article 12 – Fees for Technical Services

- Source-based taxation
- Specific definition of 'FTS' under Tax Treaty
  - Concept of 'make available' – “***Give a fish Vs. Teach how to fish***”
- Tax Treaty imposes a limitation on the maximum rate to be charged by the source country
  - Generally, the condition of “beneficial owner” exists

# Article 13 – Capital Gains

- Covers gains on 'alienation' of property
  - Wide enough to cover sale, exchange, gift, etc.
- Various categories of Capital Gains
  - From immovable property - Generally taxable in the host country
  - From movable property forming business property of PE - Generally taxable in the host country
  - From shares - Varied treatment under different tax treaties
- Favorable treaties like Singapore, Mauritius
- Treaty Shopping - Azadi Bachao Andolan's case

# Summary of source rules

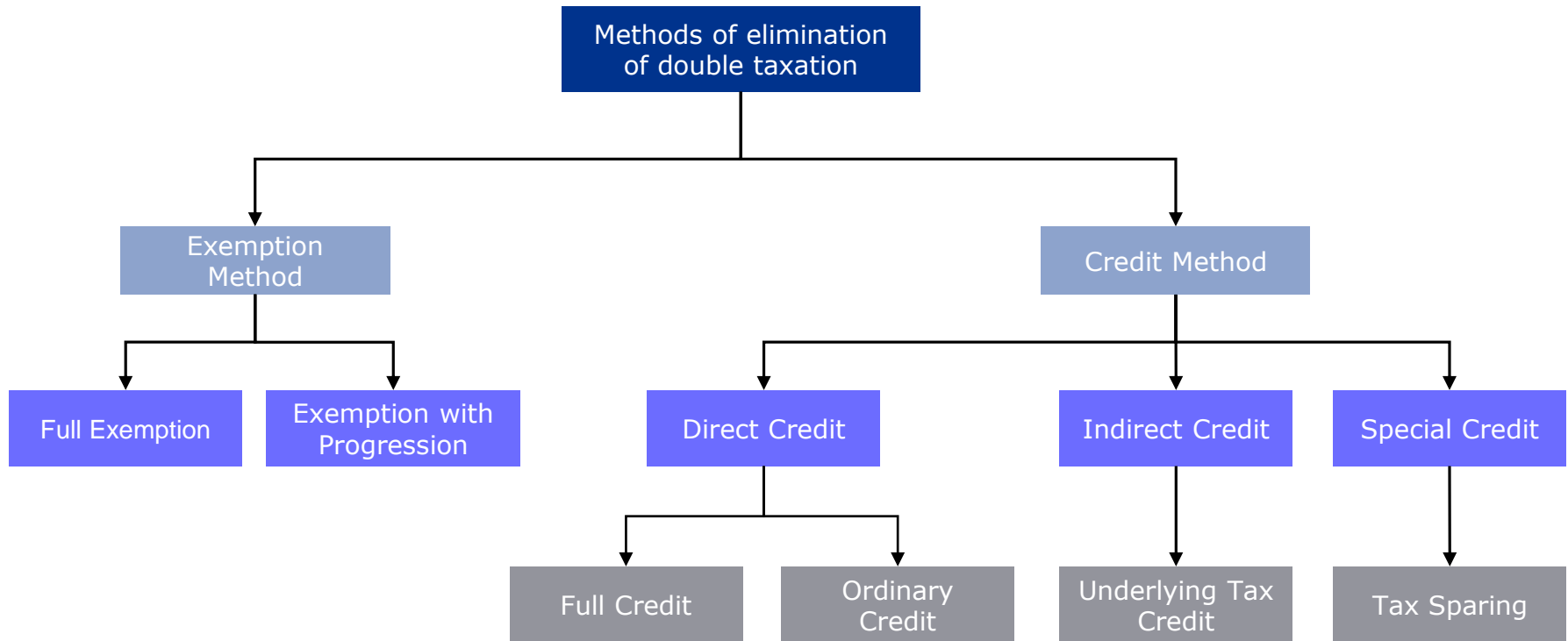
<b>Income</b>	<b>Source Rule</b>
Immovable Property	Place where situated or situs
Business Profits / Professional Services	Permanent Establishment / Fixed base
Shipping and Air Transport	Place of Management
Dividend, Interest, Royalty, FTS and Director's fees	Residence of the Payer
Employment services, Artists and Sportsman	Place of services performed
Other income	Residence of recipient

# Article 23 - Elimination of double taxation by Residence Country

- 'Exemption Method' (Article 23A of Model Conventions); and
- 'Credit Method' (Article 23B of Model Conventions)
- Concept of 'Tax Sparing'

Credit Method	Exemption Method
<ul style="list-style-type: none"><li>• Considers tax</li></ul>	<ul style="list-style-type: none"><li>• Considers income</li></ul>
<ul style="list-style-type: none"><li>• Total Tax payable is usually equal to the higher of the rates in two countries</li></ul>	<ul style="list-style-type: none"><li>• Tax could be lower than the rate in COR</li><li>• It is equal to the tax paid in COS</li></ul>
<ul style="list-style-type: none"><li>• Losses in COS are considered in COR</li></ul>	<ul style="list-style-type: none"><li>• Losses in COS ignored.</li></ul>

# Article 23 - Elimination of double taxation by Residence Country



# Underlying tax credit...

- Available to Companies resident of one Contracting State (State R) which receives dividend from Companies resident in the Other Contracting State (State S)
- Considers tax paid by company in State S
- Usually available where Company in State R holds a specified percentage of shares in the Company in State S

## ...Underlying Tax Credit – Example...

Company in State S	Amount
PBT	3,00,000
Tax @ 30%	90,000
PAT	2,10,000
Dividend distribution	2,10,000

- Company in State R holds 80% stake in Company in State S and receives dividend of 1,68,000 ( $210000 \times 80\%$ ) from Company in State S
- Tax deducted at source by State S – 33,600 ( $168,000 \times 20\%$ ); Net dividend received by Company in State R – 1,34,400
- Tax rate in State R – 35%
- Assumption: Dividend Income is the only income of Company in State R and it has no deductible expenses

# ...Credit Method: Underlying Tax Credit – Example

	<b>Amount</b>
Net Dividend Income received in State R	1,34,400
Add: Taxes withheld	33,600
Gross Dividend Income	168,000
Underlying tax credit = Gross Dividend / Distributable profits * Actual tax paid on those profits (1,68,000 / 2,10,000 * 90,000)	72,000





# Steps when referring to tax treaties



# Steps when referring to tax treaties

## Step 1 – Determine scope of convention

- Tax payer is person
- Tax payer is resident of contracting state as per article 4(1)
- Treaty applies to taxes covered as per article 2
- Applicability of treaty to the taxable period
- Treaty effect to the domestic laws of the concerned state

## Step 2 – Apply relevant definitions

- In case a person is a resident of both the states
  - Look at the Tie-breaker condition; or
  - Determine if person has PE in contracting state

## Step 3: Application of substantive provisions

- Process of characterization
- Change of character due to PE i.e. Royalty could be taxable under the business profit clause
- Commentaries to the model conventions, case laws etc provide assistance for characterization

## Step 4, 5 & 6

Step 4 – Apply the substantive article

Step 5 – Apply provisions of double taxation

Step 6 – Follow treaty provision into domestic law i.e. apply mechanism for obtaining tax credit to the taxability of the income in the relevant country

# 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



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