

Interpretation of Tax Treaties



CTC

Vispi T. Patel
Vispi T. Patel & Associates

February 06, 2015



Tax Treaty

*** A tax treaty is a formally concluded and ratified agreement between two independent nations (bilateral treaty) or more than two nations (multilateral treaty) on matters concerning taxation

*** Every nation has a right to tax its residents / nationals on their worldwide income

*** In home country (country of residence) tax is an obligation, while in host country (country of source of income) tax is a cost

*** Double Tax Avoidance Agreements (DTAA) are also known as Tax treaty and Double Tax Conventions (DTC)



Tax Treaty

** Vienna Convention on law of treaties (‘VCLT’) 1969 defines a Treaty as *“an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument and whatever its particular designation”*



Objectives of a Tax Treaty

** Objectives of a tax treaty are:

** Avoid Double Taxation

** Prevent Tax evasion

** Allocate Tax Jurisdiction

** Exchange of Information

** Promote mutual economic relations, trade and investment

** Recovery of Income-tax



Evolution of Tax Treaty....

- * 21st June 1899 – The first DTAA entered into between Prussia and Austria
- ** 1918 – US aggressiveness in giving Foreign Tax Credit (FTC)
- ** Netherland and Belgium were giving FTC to their colonies
- ** Problem became important in 1920 when group investments were started by capital exporting countries in the developing countries
- ** International chamber of commerce was setup
- ** 1921 – Four general principles were adopted at London Congress
- ** 1922 – Committee drafted resolution which was revised in 1924
- ** After 1st World War – League of nations took up this subject



...Evolution of Tax Treaty

- ** 1925 – Report on “Double Taxation and Fiscal Evasion” submitted
- ** 1928 – The first model Convention for the prevention of double taxation were developed with the concept of permanent establishment (PE)
- ** 1943 – The Mexico Model of Tax Convention was released
- ** 1946 – The London Model convention was drafted to encourage capital flow from Industrial countries to developing countries by limiting taxation to the country where income was ultimately received
- ** 1956 – The OECD (The Organisation for Economic Co-operation and Development) was setup and working on DTA Model started



...Evolution of Tax Treaty

- ** Early bilateral tax treaties (Germany)
- ** League of nations (Various Models 1922 to 1946)
- ** OEEC (Organisation for European Economic Co-operation) + OECD
- ** 1956 – Study International Double Taxation
- ** 1963 – The first draft of OECD model was published
- ** 1977 – The final version of the OECD Model was published and is being updated on an ongoing basis and latest version was in July 2010
- ** United Nations ('UN') Model – 1979, Model 1980 (Updated 2001) and UN Model Double Taxation Convention between Developed and Developing Countries 2011
- ** 1981 – US Model was introduced, revising its first Model in 1996 and now again in 2006



Types of Tax Treaties

** Limited Treaties which cover-

- income from operation of aircraft and ships,
- estates,
- inheritance and
- gifts

** Comprehensive treaties which are-
wider in scope addressing all sources of income



Treaty position in India

- *
** Section 90 of the Income-tax Act, 1961 (the Act) authorizes the Central Government to conclude tax treaties
- *
** Section 90A – Agreement between specified associations
- *
** Section 91 provides unilateral relief
- *
** Forms part of conduct of foreign affairs
- *
** Competent Authority to negotiate tax treaties : Presently Joint Secretary, Foreign Tax Division, Central Board of Direct Tax
- *
** In India, negotiations & conclusions takes place behind closed doors
- *
** Most countries have practice of placing before the Parliament, draft agreements for their approval. Unless treaties are sanctioned by the parliament, they do not have effect of law in various countries, except India



Tax Treaty Vs. Domestic Law

** Tax Treaty

- ** Agreement between two states
- ** Involves negotiation process
- ** Relief from double tax
- ** Sharing of tax revenue
- ** No frequent changes
- ** International law
- ** Dispute settled by
Appellate Forum / Court/
Mutual Agreement
Procedure (MAP)

** Domestic Law

- ** Power of every sovereign nation to tax
- ** Act of Legislation under the Constitution
- ** No negotiation
- ** Charge of tax
- ** Earning of tax revenue
- ** Frequent amendments
- ** Dispute settled by Appellate forum/ Court



Typical Structure of Tax Treaties as per UN Model

- *
** Scope of Convention
- *
** Definitions
- *
** Taxation of income
- *
** Taxation of capital
- *
** Provisions for elimination of Double Tax
- *
** Special Provisions such as Anti-Avoidance Provisions
- *
** Miscellaneous Provisions
- *
** Protocols and Termination



Articles - Classification

Scope Provisions

- Article 1- Persons covered
- Article 2- Taxes Covered
- Article 29 – Entry in Force
- Article 30- Termination

Definition Provisions

- Article 3- General Definitions
- Article 4- Residence
- Article 5 – Permanent Establishment

Anti-Avoidance Provisions

- Article 9- Associated Enterprises
- Article 26- Exchange of information

Elimination of Double Taxation

- Article 23A –
By elimination method
- Article 23B –
By credit method
- Article 25 - Mutual Agreement procedure

Miscellaneous Provisions

- Article 24- Non-Discrimination
- Article 27- Diplomats
- Article 28- Territorial extension

Substantive Articles (Article No 6 to 22, except 9)

Applies to particular categories of income, capital gains, capital and allocation of taxing jurisdictions, etc

- ** Article 6 – Immovable Property
- ** Article 7 - Business Profits
- ** Article 8 – Shipping, etc.
- ** Article 10 – Dividends
- ** Article 11 - Interest
- ** Article 12 – Royalty & Fees for Technical Services
- ** Article 13 – Capital Gains
- ** Article 14 – Independent Personal Services

- ** Article 15 – Dependent Personal Services
- ** Article 16 – Directors' fee
- ** Article 17 – Artistes & Sports Persons
- ** Article 18 – Pensions
- ** Article 19 – Government Services
- ** Article 20 – Students
- ** Article 21 – Other Income
- ** Article 22 – Capital

Prominent Articles – Scope Of Convention (Articles 1 & 2)

* Article 1 – Application of tax treaty

Applies to a person who is a resident of one or both the contracting states. Hence, it does not apply to persons who are not residents of either of the contracting states. The term ‘person’ is defined in Article 3 of the Model Convention

* Article 2 - Taxes Covered

* Taxes on income

* Taxes on capital

* List of taxes

* Irrespective of authority on behalf of which such taxes are imposed

* Irrespective of the method by which the taxes are levied

Prominent Articles – Definition (Articles 3,4 & 5)

** Article 3 – General Definitions

** Person (an individual, a company and any other body of persons)

** Company (any body corporate or any entity that is treated as a body corporate for tax purposes)

** Enterprise of a Contracting State / other Contracting State

** International traffic (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)



Prominent Articles – Definition (Articles 3,4 & 5)

** Article 3 – General Definitions

** Competent Authority

** National (any individual possessing the nationality of a Contracting State, any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State)



Article 3(2)

*Article 3(2) – Undefined terms

The terms which are undefined are to be understood and interpreted as per the domestic tax laws applicable to the taxes covered in the treaty

*** “As regards the application of the Convention at any time by a Contracting state, any term not defined therein shall, unless the context otherwise required, have the meaning that it has at that time under the law of the 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”*



Territorial Scope

- ✱✱ Provided in Article 3 of Tax Treaties
- ✱✱ Generally India is defined to mean territory of India and includes territorial sea and the air space above it, as well as other maritime zone in which India has sovereign rights, other rights and jurisdictions, according to the Indian law and in accordance with the international law
- ✱✱ Similarly other Contracting State provide for its territorial scope
- ✱✱ Necessary for application of tax treaty

Section 2(25A) of the Act defines India as follows:

“India” means the territory of India as referred to in Article 1 of the Constitution, its territorial waters, seabed and subsoil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 (80 of 1976), and the air space above the territory and territorial waters”

Prominent Articles - Definition

** Article 4 – Residence

A person is a resident of a country if he is liable to tax in the country by virtue of :

** Domicile

** Residence

** Place of incorporation

** Place of management

** Any other criteria of a similar nature

** The term ‘resident of a Contracting State’, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein



Prominent Articles - Definition

** Article 4 – Residence

** Tie Breaker Rules in case of individuals (in the case of dual residence)

** *Permanent home test* –

** Resident of the State where the taxpayer has a permanent home available to him

** If taxpayer has permanent home available in both States, than he is deemed to be resident of the State with which his personal and economic relations (*‘centre of vital interests’*) are closer



Prominent Articles - Definition

** Article 4 – Residence

** Tie Breaker Rules in case of individuals (in the case of dual residence)

** *Habitual abode test* –

** If centre of vital interest of taxpayer remains indeterminate, or if he does not have a permanent home available in either State, he is deemed to be resident of the State where he has habitual abode

** ‘Abode’ means a place where a person lives

** ‘Habitual abode’ would imply continuous, repeated and persistent stay



Prominent Articles - Definition

** Article 4 – Residence

** Tie Breaker Rules in case of individuals (in the case of dual residence)

** Nationality test –

** Taxpayer has habitual abode available in both States or in neither State, he is deemed to be resident of the State of which he is national

** Lastly, if taxpayer is national of both the States or of neither State, the competent authorities of both States shall determine his residence by mutual agreement



Prominent Articles - Definition

** Article 4 – Residence

** Tier Breaker Rules in case of non-individuals (in the case of dual residence)

** A non-individual who is resident of both the States would be deemed to be resident only of the State in which its 'place of effective management' is situated

* The model DTAA does not define the term 'effective management'. Briefly, it is the place where the company is *de facto* managed

** It should be ascertained on the facts of each case (no thumb rule for ascertaining the 'place of effective management')



Concept of subject to tax and liable to tax

- ** Liable to tax “covers both current as well as potential double taxation”
- ** Being liable to tax in a country does not necessarily mean that the person should actually be liable to tax in that country by virtue of an existing legal provision
- ** It would also cover cases where that country has the right to tax such person irrespective of whether or not such a right is exercised by the country

****Mumbai Tribunal in the case of ADIT Vs. Green Emirates Shipping & Travels Limited [2006] 100 ITD 203 (Mum)**

****Mumbai Tribunal followed principles of Green Emirates in the below cases:**

- 1. Resource Connections (FZE) [2010] 42 SOT 23 (Mum)**
- 2. ITO vs. Mahavirchand Mehta [2011] 45 SOT 137 (Mum)**

Prominent Articles - Definition

** Article 5 – Permanent Establishment

** Means a fixed place from where the business of the enterprise is wholly or partly carried on

** PE includes place of management, branch, office, factory, workshop, mine, quarry, an oil or gas well, a construction site for long duration, a services location for long duration and a dependent agency with power to conclude contracts

** Construction PE where period lasts for more than 6 months

** Service PE, including consultancy services (for same or connected projects) for period or periods aggregating more than 183 days in any 12 month period commencing or ending in the fiscal year concerned

** Conditions to constitute a permanent establishment – Fixed place of business, business activity, business connection



Prominent Articles - Definition

- *^{*} Conditions to constitute a permanent establishment
- *^{*} Fixed place of business
 - *^{*} Objective presence in other country
 - *^{*} Two embedded conditions:
 - *^{*} Place of business and right to use it with a certain degree of permanence
 - *^{*} Specific location
 - *^{*} Most significant feature of PE as distinguished from source state taxation
 - *^{*} Emphasizes establishment of the enterprise rather than source of income
 - *^{*} Enterprise's presence has to be 'visible'



Prominent Articles - Definition

* * * The Positive List

- *
*
* consists of places which are 'prima facie' PE; additional requirements to be met like right of use of the place of business and the performance of business activity through it

* * * The Negative List

- *
*
* consists of places specifically exempted; may overrule the primacy of the positive list



Prominent Articles - Definition

- *
** Business activity (BA) –
 - *
** Tax treaties characterize a fixed place as a permanent establishment only if the enterprise undertakes a business activity through it
- *
** Threshold requirements of BA
 - *
** Tangible Connection Fixed Place
 - *
** Nature & level of Business Activity
 - *
** People Presence Virtual – PE
- *
** Some BA specifically excluded
- *
** BA to be differentiated from other income generating activities e.g. dividend, interest, royalty, capital gains etc.
- *
** Core BA differentiated from minor, auxiliary or preparatory activities
- *
** BA to be performed through the place of business



Prominent Articles - Definition

* ** Tests of Business Activity

*
** Asset Value Test - Activities which increase the asset value of the enterprise are core business activities

*
** Regrouping of Capital Resources Test - The principle tries to establish a rule that an enterprise uses its assets to yield income, rather than merely earning income by letting out assets

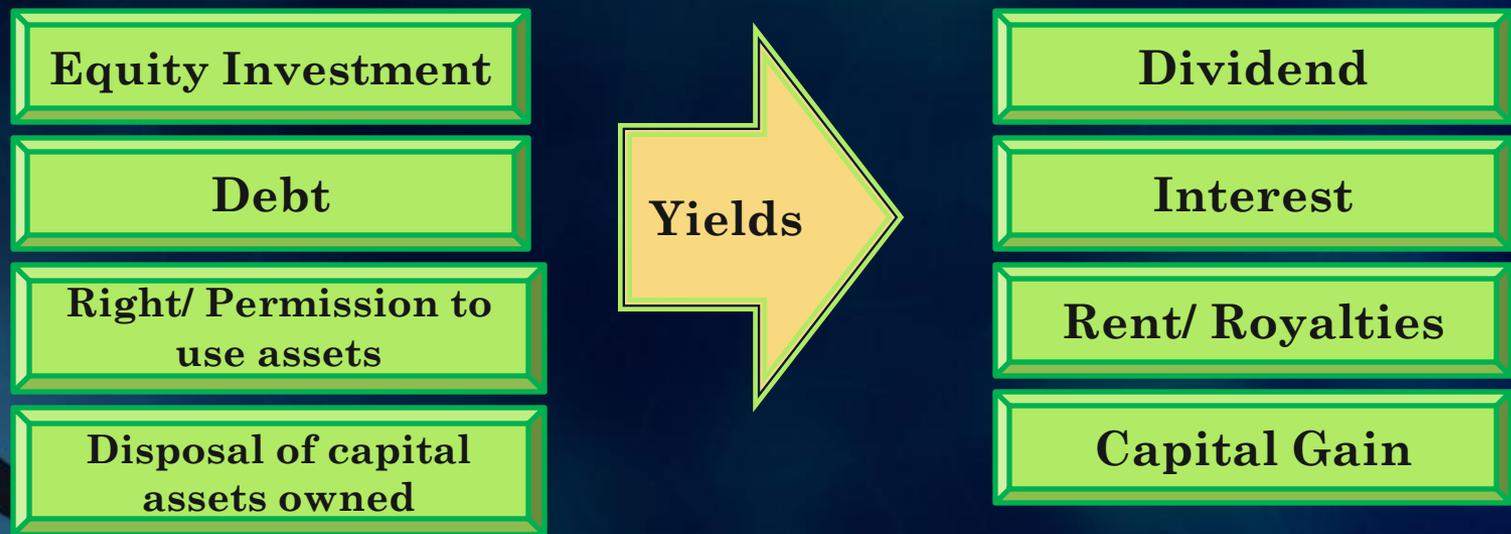
*
** The Business Connection Test - The PE definition requires a specific connection between the business activity and the fixed place of business. Even automated machinery, computers could perform the activity and fulfill this test



Distributive Provisions

** Active & Passive Income

** Passive Income refers to income derived from investment in tangible/ intangible assets



** Active Income is the income derived from carrying on active cross border business operations or by personal effort and exertion as in case of employment

Passive Incomes – Distribution of Taxing Rights

Articles	Remarks
Article 6 – Income from Immovable property	Unrestricted taxation by Source Country allowed
Article 10 – Dividend Income	Taxation by Source Country limited to an agreed rate of tax as per DTAA by bilateral negotiations (5 – 15%)
Article 11 – Interest Income	Taxation by Source Country limited to an agreed rate of tax as per DTAA by bilateral negotiations (10%)
Article 18 – Pensions	Normally, taxation by the Country of Residence. However, Source Country can also tax such pensions if paid by the resident of that Contracting State or PE situated there

Passive Incomes – Distribution of Taxing Rights

** Article 12 – Royalty and Fees for Technical Services (FTS)

1. Royalties/ FTS arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other state
2. Such royalties/ FTS may also be taxed in the Contracting State in which it arises and according to the laws of that State
3. If the beneficial owner is a resident of the other Contracting State the tax so charged shall not exceed 10% to 20%, (to be established through bilateral negotiations)



Passive Incomes – Distribution of Taxing Rights

** Article 13 – Capital Gains

** Taxation by source State of gains from alienation of immovable property situated in such State (referred to in Article 6)

** Taxation by source State of gains from alienation of movable property forming part of PE / fixed base of a resident of the other Contracting State

** Taxation by the Contracting State in which the place of effective management of the enterprise is situated, for gains from alienation of ships/ aircraft operating in international traffic, boats engaged in inland waterways transport or movable property pertaining to such operation



Passive Incomes – Distribution of Taxing Rights

** Article 13 – Capital Gains

** Gains from alienation of stock/ shares of a company may be taxed in the Contracting State in which such company is a resident

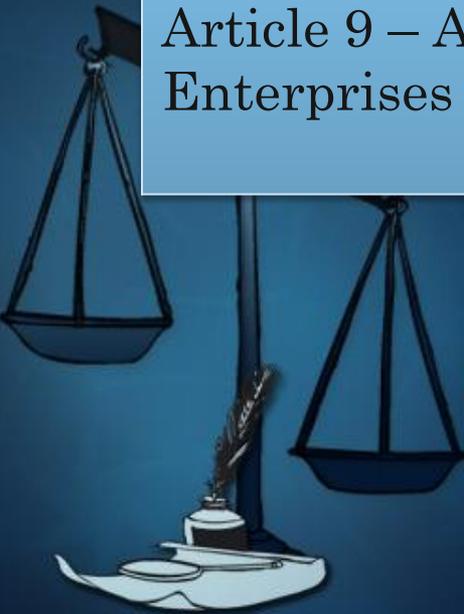
** Gains from alienation of stock/ shares of a company/ interest in a partnership, trust, etc. holding principally immovable property situated in a Contracting State may be taxed in that State

** All other gains from alienation of any property taxable in that Contracting State of which the alienator is resident



Active Incomes – Distribution of Taxing Rights

Articles	Remarks
Article 8 – Shipping and Air Transport	Exclusive taxation by the Country where the place of effective management is located from the operations of ships or aircraft in international traffic
Article 9 – Associated Enterprises	<ul style="list-style-type: none">• Right to adjust transfer prices• Corresponding adjustment by Other state



Active Incomes – Distribution of Taxing Rights

Articles	Remarks
Article 16 - Directors Fees	Taxation by Contracting State of which such Company is resident from which such income is derived
Article 17 – Artiste & Athletes	Taxation by Source Country is allowed
Article 19 – Government Service	Taxation by Country for which the services are rendered to that State/ subdivision/ authority
Article 20 – Students	Payments from outside country of study not taxable in that State
Article 21- Other Income	Exclusive taxation by Country of residence except if income relates to a permanent establishment

Active Incomes – Distribution of Taxing Rights

* Article 7 – Business Profits

** Taxation of profits by a Contracting State if the enterprise carries on business through a PE situated therein

** Allowed to the extent profit attributable to that PE, sales in that other state of goods or merchandise of same or similar kind as those sold through that PE other business activities carried on in that other State of same or similar kind as those effected through that PE



Active Incomes – Distribution of Taxing Rights

* Article 14 – Independent Personal Services



** Income derived by a resident of a Contracting State shall be taxable only in that State

* In following cases such income may also be taxed in the other Contracting State

** If he has a fixed base in the Other Contracting State – only so much of income as is attributable to that fixed base may be taxed in that other Contracting State, or

* If his stay in other Contracting state is for a period of 183 days or more in any 12 month period - only so much of the income as is derived from his activities performed in that State may be taxed in that other State



Active Incomes – Distribution of Taxing Rights

* Article 15 – Dependent Personal Services

Remuneration derived by a resident of a Contracting State in respect of employment exercised in the other Contracting State shall be taxable only in the first mentioned State if:

- * the recipient is present in other Contracting State for a period of 183 days or less in any 12 month period
- * the remuneration is paid by or on behalf of an employer who is not a resident of the other State
- * remuneration is not borne by a PE or a fixed base which the employer has in the other State



Taxation of Capital (Article 22)

** Capital

** Source country taxation allowed for:

** Immovable Property

** Business assets of a PE or fixed base

** Special Rule for shipping, etc.



Elimination of Double Taxation (Article 23)

****** Double Taxation occurs when

****** Worldwide taxation plus source taxation; or

****** Residence in two countries

****** Double Taxation is eliminated by

****** Allocation of exclusive right to tax

****** Sharing taxing rights

Juridical Double Taxation

Two or more states levy taxes on same entity or person on same income for identical periods

It is the result of a conflict between two tax systems

It arises due to overlapping claims of tax jurisdictions on interrelated economic activities

Economic Double Taxation

Same economic transaction, item or income is taxed in two or more states during the same period but in the hands of different taxpayers

Elimination of Double Taxation (Article 23)

** Article 23 – Alternate methods are as below

** The Exemption Method (Article 23A)

** Full exemption

** Exemption with progression

** The Credit Method (Article 23B)

** Direct credit

** Full credit

** Ordinary credit

** Indirect credit

** Underlying tax credit

** Special credit

** Tax sparing



Special Provisions (Articles 24 to 29)

Article Ref.	Title
24.	Non-Discrimination
25.	Mutual Agreement Procedure
26.	Exchange of information
27.	Assistance in the collection of taxes
28.	Members of Diplomatic Missions and Consular Posts
29.	Territorial Extension



Final Provisions(Articles 30 to 31)

Article Ref.	Title
30.	Entry into force of the Convention <ul style="list-style-type: none">• Date of entry into force• Date of effect
31.	Termination of the Convention



Entry into force

Date of Convention

- Date on which convention is signed
- Mentioned at the end of every treaty

Date of Ratification

Ratification of Treaty by the legislative/ executive consent in each contracting state in accordance with domestic laws

Date of Exchange of Notes

- Notes are exchanged between contracting states
- Ratification of treaty in each state

Date of Entry into force*

Treaty enters into force either upon the date of exchange of notes or a period thereafter as specified in relevant treaty

Effective Date*

Treaty provisions becomes effective in respective contracting states on the dates specified in relevant treaty

Date of entry into force & effective date of application may not be the same dates

Protocols and Termination

** Protocols / MOUs

- ** Generally provides amendments to the existing treaties
- ** Provides for explanation to the treaty provision – specific in case of Indo – US tax treaty

** Termination

- ** Treaty remains into force till terminated
- ** Some treaties provide for a period during which treaty cannot be terminated e.g. Indo – US tax treaty
- ** Termination requires notice through Diplomatic Channels
- ** Some treaties provide for period of notice



Principles of Interpretation of Treaty

- *^{*} Interpretation of Tax Treaty Vs. Interpretation of Domestic Laws
 - *^{*} intentions of two Countries involved
 - *^{*} treaties often use terms not used in domestic law
 - *^{*} treaties are more generally worded
 - *^{*} Leading to double taxation or double non-taxation



Principles of Interpretation of Treaty

* Basic Rules for interpretation of domestic law

** Rule of Literal Interpretation :

** Intention of the legislation must be found in the words used by the legislature itself. Legislative intent as stated in the text of the law

** Rule of Purposive Interpretation :

** Modern version of the mischief rule

** Certainly more flexible than either the literal rule or the golden rule which tend to concentrate upon the meaning of individual words or phrases

** Allows Court to add or ignore words in the Act to help them give a decision that supports in their view why the Act was created



Important Principles of International Law applicable to Tax Treaties

- *
** Principles enunciated by the International Court of Justice
- *
** Tax treaties are a legal obligation for the contracting states from the standpoint of public international law
- *
** The binding nature of these principles on domestic courts and taxpayers depend on rules of Constitutional Law
- *
** Tax treaties interpretation in the context of the treaty to be examined according to Articles 31, 32 and 33 of Vienna Convention on the Law of Treaties (VCLT), mutual agreements between CAs



Principles of Interpretation of Treaty

- *
** UOI vs. Azadi Bachao Andalan (SC) (263 ITR 706)
 - Principles adopted in interpretation of treaties not same as interpretation of statutory legislation

- Commentary of Francis Bennion

“Interpretation of treaty imported into municipal law by indirect enactment – described by Lord Wilberforce as being ‘unconstrained by technical rules of English law, or by English legal precedent, but conducted on broad principles of general acceptance... Words are to be given their general meaning, the meaning of the diplomat rather than the lawyer’”

- *
** Interpretation to take care of considerations based on which treaty is negotiated and entered at political level



Principles of Interpretation

- ** Governed by the Vienna Convention on the Law of Treaties (VCLT)
 - ** Codification of existing international law
 - ** Criteria of interpretation – Articles 31 & 32 of VCLT

Identifies most important elements of interpretation, puts them in a relationship to each other and aids the interpreter in assigning relative weights to the different elements

- ** Important articles of Vienna Convention which are relevant for taxation purposes are following



Principles of Interpretation

** Article 31 of Vienna Convention

** General rule of interpretation

** *Article 31(1)-Basic rule of general validity*

A treaty shall be interpreted in good faith, in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose

** *Article 31(2)-Definition of the term 'Context'*

** Text including preamble and annexes

** Agreement relating to treaty made in past

** Instrument related to the treaty made and accepted by one or more parties in the past



Principles of Interpretation

** Article 31 of Vienna Convention - General rule of interpretation

** *Article 31(3) - In addition to the context, following should be considered*

** Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions

** Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation

** Any relevant applicable rules of international law applicable in the relations between the parties

** *Article 31(4) - A Special meaning shall be given to a term if it is established that the parties so intended*



Principles of Interpretation

****** Article 32 of Vienna Convention - Supplementary means of interpretation

****** Includes preparatory work of the treaty and the circumstances of its conclusion

****** Recourse may be had in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:

****** leaves the meaning ambiguous or obscure; or

****** leads to a result which is manifestly absurd or unreasonable.



Principles of Interpretation

* Article 33 of Vienna Convention

* Interpretation of treaties authenticated in two or more languages

* The text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail

* A version treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree

* The terms of the treaty are presumed to have the same meaning in each authentic text

* Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted



Aids to interpretation

- *
** OECD / UN Model conventions and commentary
- *
** Protocols
- *
** Technical memorandum
- *
** Parallel treaties
- *
** International case laws
- *
** Preparatory work and the circumstances of its conclusion



Beneficial Ownership

- *
* The term “beneficial ownership” is neither defined in the Income-tax Act nor in the DTAA
- *
* Introduced in 1977 in Model Convention as an anti-avoidance measure to stop improper use of tax treaties
- *
* Mainly found in Articles dealing with dividend, interest, royalties & FTS
- *
* Found in certain provisions of Indian Income-tax Act i.e. Sections 2(18), 2(22)(e), 40A(2), etc. of the Act
- *
* Distinction with legal owner
- *
* One who enjoys right to receive income from the property or right to transfer the property

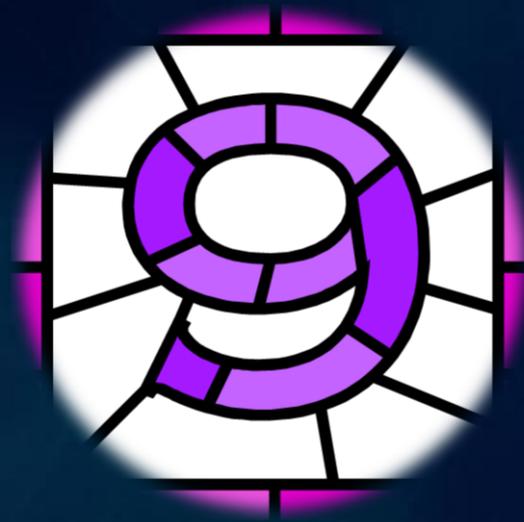


Beneficial Ownership

****** According to the learned Author Late. Prof./ Dr. Klaus Vogel, “*the beneficial owner is he who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields therefrom should be used or (3) both*”



Article 9 of Model Tax Conventions



Indian TPR

** Section 92 - Income arising to “Associated Enterprises” from “International Transactions” (or Specified Domestic Transactions w.e.f AY 2013-14) shall be computed having regard to the “Arm’s Length Price (ALP)”

** OECD TP Guidelines have laid the foundation of the Transfer Pricing Regulations in India

** Preconditions:

** Two or more associated enterprises

** Enter into an international transaction

** Specified Domestic Transaction (w.e.f. AY 2013-14)

** Consequence:

** Income/ Expenditure to be computed having regard to the arm’s length price



Meaning of Associated Enterprises (AEs) – As per Indian TPR

* Section 92A – AE means direct or indirect participation in management control or capital:
** by one enterprise into another enterprise; or
** by the same person in both the enterprises

** Equity holding, Control of Board of Directors / Appointment of one or more Executive Director, mutual interest will also constitute Associated Enterprise

** Either or both of Associated Enterprises should be non-residents



Meaning of Aes.....

- ** “Deemed Associated Enterprises” includes:
 - ** Holding of 26% of voting power
 - ** by one enterprise into another enterprise; or
 - ** by the same person in both the enterprises
 - ** Dependence on intangible assets
 - ** Sale of goods
 - ** influence on price and conditions of supply by buyer
 - ** Control by individual or his relative
 - ** Financial transaction
 - ** Loan - 51% or more of book value of total assets of the borrowing enterprise
 - ** Guarantee - 10 % or more of the total borrowings of an enterprise



Meaning of AEs as per OECD Model Tax Convention

- ** Article 9(1) of OECD “ *Where direct or indirect participation in management, control or capital:*
 - ** by one enterprise into another enterprise; or*
 - ** by the same person in both the enterprises***
- ** Then any profits which would accrue to either one of enterprises but have not accrued due to controlled conditions will be included in profits of that enterprise and taxed accordingly “**

- ** The likely purpose of Article 9 (1) is that, it restricts domestic law only to the extent of application of Arm’s Length Principle for adjustment purposes**

Whether definition of AE under domestic law can be reduced in rigor by falling under relevant article of AE under the treaty ?



Specified Domestic Transactions

- ** The Finance Act ,2012 has introduced TPR for specified domestic transactions under section 92BA
- ** Specified Domestic Transactions to include :
 - ** Expenditure in relation to which payment has been made to related party as per section 40A(2)
 - ** Transfer of goods or services between two units, undertakings or companies which are related and one of them is eligible to avail deduction under Chapter VI-A, 80IA etc.
 - ** Any transaction in Chapter VI-A or Section 10AA to which the transfer pricing clause under section 80IA are specifically made applicable
 - ** Any other transaction as may be prescribed



Analysis of the Bombay High Court Judgment in Vodafone India Services Limited (Writ Petition No. 871 of 2014) Bombay High Court

- * The word income as defined in Section 2(24) of the Act, though an inclusive definition, cannot include capital receipts unless it is so specified, as in Section 2(24)(vi) of the Act
- ** Capital gains chargeable to tax under Section 45 of the Act are, defined to be income
- ** The amounts received on issue of share capital including the premium were undoubtedly on capital account
- ** Due to absent express legislation; no amount received, accrued or arising on capital account transaction can be subjected to tax as income



**Reliance on the decision of :
Bombay High Court in Cadell Weaving Mill Co.
vs. CIT 249 ITR 265, which was upheld by the
Apex court in CIT v. D. P. Sandu Bros. Chember
(P) Ltd. 273 ITR 1**

Analysis of the Bombay High Court Judgment in Vodafone India Services Limited ...

** Chapter X of the Act is a machinery provision to arrive at the ALP of a transaction between associated enterprises (AEs)

** The substantive charging provisions are found in Sections 4, 5 (Scope of income), 15 (Salaries), 22 (Income from house property), 28 (Profits and gains of business), 45 (Capital gain) and 56 (Income from other Sources) of the Act

** An income arising from an international transaction between AE must satisfy the test of income under the Act and must find its home in one of the above heads i.e. charging provisions, as Chapter X is only a machinery provision to compute the chargeable income at ALP

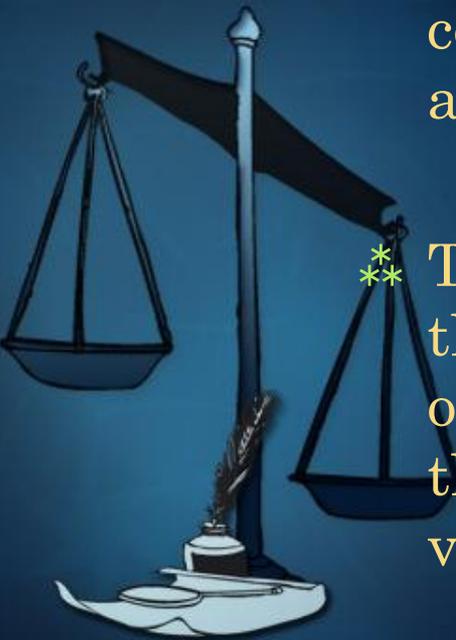


Analysis of the Bombay High Court Judgment in Vodafone India Services Limited ...

*
** Machinery section cannot be read de-hors the charging section, relying on the observations of the Supreme Court in CIT v. B. C. Srinivas Shetty 128 ITR 294

*
** The HC concluded that the issue of shares at a premium by the assessee to its non-resident holding company does not give rise to any income from an admitted international transaction

*
** Thus, there was no occasion to apply Chapter X of the Act in such a case. The HC quashed all the orders of the Revenue authorities i.e. AO/ TPO/ DRP and set them aside as being without jurisdiction, null and void



THANK YOU



Vispi T. Patel

Vispi T. Patel & Associates

Chartered Accountants

Contact no : +91 22 2288 1091/1092

+91 -98 6763 5555

Email id : vispitpatel@vispitpatel.com

