ICAI – BASICS OF INTERNATIONAL TAXATION

Article 10,11,13

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PASSIVE INCOME
PASSIVE INCOME - OVERVIEW

- **Passive income** is an income received on a regular basis, with little effort required to maintain it.

- Some examples of passive income are:
  - Rent;
  - Royalties;
  - Dividends; or
  - Interest

- Passive Income is chargeable to tax on a gross basis

- Passive Income would be subject to tax in the hands of the person twice, if such person earns income from one country and the same person is a resident of another country (Juridical Double Taxation)

- In order to avoid such double taxation, two countries enter into tax treaties.
Active v. Passive income

Capital employed
- Equity
- Debt
- Permission to use assets
- Purchase with subsequent disposal

Passive incomes
- Dividends
- Interest
- Royalties
- Capital gains

Activities
- Employment
- Professional service

Active incomes
- Dependent personnel service
- Independent personnel service
### Domestic taxation of dividends

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<td>Yes</td>
<td>Yes</td>
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<td>Taxes dividends when distributed</td>
<td>Yes</td>
<td>No*</td>
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<td>Credit for corporate income tax paid</td>
<td>No</td>
<td>Partial</td>
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<td>Yes</td>
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* Dividend tax credit is granted to shareholders, calculated according to dividends distributed but limited by reference to corporate tax paid with respect to the profits distributed.
DIVIDEND - OVERVIEW

- Article 10(1) – Distributive Rule
- Article 10(2) – Taxing rights of Source Country
- Article 10(3) – Definition of ‘Dividend’
- Article 10(4) – Exclusion in case of PE
- Article 10(5) – No Extra-territorial taxation
ARTICLE 10(1) – DISTRIBUTIVE RIGHTS

Article 10(1) reads as under:

“Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.”

Country of residence has the right to tax the dividend income.

Taxation is of dividend ‘paid’ – Hence, it would be necessary to understand the meaning of the term paid.

Paid Means

The term ‘paid’ has a very wide meaning, since the concept of payment means the fulfillment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or custom – Para 7 of Article 10 of the OECD Commentary.
ARTICLE 10(1) – MEANING OF THE TERM PAID

‘Paid’ means actually paid or incurred according to the method of accounting upon the basis of which the profits or gains are computed under the head ‘Profits and Gains of Business or Profession’ – Section 43(2) of the Income-tax Act

Further, it would be important to note sub section 1 of section 145 of the Act, which reads as under:

- Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

In the case of Raghava Reddi vs. CIT (44 ITR 720)(SC) it has been held that once the amounts were transferred to the account of the non-resident and the money was dispersed as per the directions of the non-resident, then such amount would be taxable in India.
MEANING OF TERM ‘PAID’ – JUDICIAL PRECEDENTS

- In the case of CIT vs. Toshoku Limited (125 ITR 525) (SC) it has been held that making of book entries in the books of the Indian Company cannot amount to receipt in the hands of the non-resident, since the amounts so credited were not at the disposal or control of the non-resident.

- In the case of CIT vs. Standard Triumph Motor Company Ltd. (201 ITR 391)(SC) it has been held that Credit entry in books of payer to account of payee amounts to its receipt by payee.

- In the case of J Dalmia vs. CIT (53 ITR 83) (SC) the Supreme Court has explained the expression “paid” does not contemplate actual receipt of dividend. Dividend may be regarded as “paid” when the company discharges its liability and makes the amount of dividend unconditionally available to the shareholders.

- The AAR in the case of Flakt (India) Ltd (267 ITR 727) (AAR) held that the term “paid” in Article 10(1) is irrelevant in deciding the stage at which the dividends are taxable in the Source Country.
MEANING OF TERM ‘PAID’ – JUDICIAL PRECEDENTS

In case of Pfizer Corpn. v. CIT (259 ITR 391) the Bombay High Court held as under

- A dividend declared by an Indian Company, would deem to accrue in India. But what happens in a situation when dividend is declared in India and paid to a non-resident outside India?

- To cover such a situation, section 5(2)(b) has to be read with section 9(1)(iv) of the Act. Section 9(1)(iv) of the Act clearly stipulates that a dividend paid by an India company outside India will constitute income deemed to accrue in India on effecting such payment.

- ‘Declared or distributed’ occurring in section 8 do not find place in section 9(1)(iv) – Section 8 is a part of computation machinery and not a charging section

- Dividend paid to non-resident outside India deemed to accrue in India only on receipt of RBI approval and not on declaration – debt arose only on approval of the RBI
MEANING OF TERM ‘PAID’ – SUMMARY

- Method of Accounting regularly adopted by the assessee (non-resident) would not be relevant for determining the tax liability of the non-resident in India. Method of accounting adopted by the assessee would determine the year of taxability.

- The charge under the Act is created under Section 4 and Section 5 of the Act.

- If an income accrues in India in year 1 and is paid to the non-resident in year 3, then in such a circumstance such income would be subject to tax in the year of payment, i.e., year 3, if the non-resident entity regularly adopts cash basis of accounting.

- Even if the funds are disposed off in accordance with the directions given by the non-resident, then such income would subject to tax.
MEANING OF TERM ‘MAY BE TAXED’

- Earlier the term ‘May be taxed’ was interpreted to mean that the one country would have exclusive right to tax the income and once the taxpayer has paid taxes in the Country of Source/Residence, the other country would lose its right to tax such income. Such a view was upheld by the Supreme Court in the case of Turquoise Investments and Finance Limited (300 ITR 1) (SC)

- However, the above mentioned decision and various other decisions were rendered before the FY 2003-04, when Section 90(3) of the Act was introduced empowering the Government to issue notifications for clarifying any term used in the Tax Treaty if the same has not been defined in the Tax Treaty or under the Act

- Using this power the CBDT issued a Notification No.91 of 2008 which envisages that where a Tax Treaty provides that any income of a resident in India ‘may be taxed’ in other country, such income shall be offered to tax in India, and credit shall be available for taxes paid abroad.
Based on the above Mumbai Bench of the Tribunal in the case of Essar Oil Limited (ITA No.2428/MUM/2007) the ITAT held that taxing rights is not exclusive to the State of Source or Residence where the term ‘may be taxed’ has been used in the Tax Treaty.

The decision opens up the debate if a term which is not defined under the Act, can the same be defined by a notification (which is an action of the tax department) and say that this was the intention with which the treaties were entered into.

Such unilateral ability to define a term used in the treaty through a notification could come under greater focus and challenge in the future and could have far reaching consequences.
ARTICLE 10(2) – TAXING RIGHTS OF THE SOURCE COUNTRY

Article 10(2) reads as under:

“However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

b) 15 per cent of the gross amount of the dividends in all other cases

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.
Hence, Article 10(2) provides for that the Source Country can also tax the dividend subject to the threshold limit (As agreed by member the states).

Such taxation would be done at gross amounts.

Taxation in source country is in accordance with its domestic law.

Pre-requisite to for Article 10(2) to apply -

- **Beneficial owner** is the resident of the Other State
- Limited right to tax in source country on gross basis

Further, the Article does not impact the taxation of the Company paying such dividend.

Dividend declared by an Indian Company under section 115O is exempt from tax in the hands of the shareholder as per domestic law.

Hence, Para 2 may not be relevant, in cases of India as source state.
Dividend declared by an Indian Company is exempt, hence Para 2 may not be relevant??

- Lets discuss
Facts of the case

- M Co holds more than 10 percent of total equity share capital of I Co
- I Co proposes to pay dividend to M Co

**Taxability under Act**

- I Co to pay DDT @ 15 percent under section 115-O of the Act on dividends proposed to be paid to M Co
- Dividend income – tax exempt for M Co under section 10(34) of the Act

**Taxability under DTAA**

- Eligibility of I Co to apply DTAA rate for DDT?
Section 10(34) exempts dividend referred to in section 115O whether received by a resident or non-resident. Section 10(34) reads as under:

10. In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included—
(34) any income by way of dividends referred to in section 115-O;

Further Explanation below section 115Q gives the meaning of dividend for the purpose of section 115O. It reads as under:

Explanation.—For the purposes of this Chapter, the expression "dividends" shall have the same meaning as is given to "dividend" in clause (22) of section 2 but shall not include sub-clause (e) thereof.

Thus other than deemed dividend referred to in section 2(22)(e), all other dividend are governed by section 115O.
Tax under section 115O – Is it a tax on dividend?

Godrej and Boyce Mfg Co. Ltd. v. DCIT (2010) 328 ITR 81 (Bom)

The effect of section 115-O is that in addition to the income-tax chargeable on the total income of a domestic company, additional income-tax is charged on profits declared, distributed or paid. This tax which is referred to as a tax on distributed profits is what it means, namely, a tax on the profits of the company. This is not a tax on dividend income. Under section 115-O, the charge is on a component of the profits of the company; that component representing profits declared, distributed or paid. The tax under section 115-O is not a tax which is paid by the company on behalf of the shareholder, nor does the company act as an agent of the shareholder in paying the tax. This legal position is fortified by the circumstance that the shareholder is not entitled to any deduction in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon.

Arguments against the above view

Prior to introduction of section 115O by the Finance Act 1997, dividend was taxable in the hands of shareholders as income from other sources. The said charging section was abolished by introduction of section 115O and dividend was made exempt under the provisions of section 10(33).

Possible to argue that onus merely shifted from shareholder to company
Tax under section 115O – Is it a tax on dividend?

The Circular issued by the Central Board of Direct Taxes on February 18, 1998, explaining the provisions of the Finance Act of 1997, which introduced the provisions of section 115O notes that in order to avoid huge amount of paperwork, a new system of collecting tax on profits distributed by companies by way of dividend is introduced in addition to income tax chargeable in respect of the total income of the company.

Possible to argue that intent was only to charge tax on dividend from a single point for avoiding paperwork?

Relevant extract of Memorandum to Finance Bill, 2003 introducing section 10(34)

… It has been argued that it is easier to collect tax at a single point, i.e., from the company rather than compel the company to compute the tax deductible in the hands of the shareholders…

The Finance Minister while presenting the Finance Bill 2014 in his budget speech in Para 206 stated that

In the year 2003, the tax liability on income by way of dividends was shifted from the shareholder to the company. The shareholder was required to pay tax on the gross dividends, but now the company pays tax on the dividend amount net of taxes.
Tax under section 115O – Is it a tax on dividend?

- It may be noted that the statement of objects and reasons can be looked into for the purpose of finding out the intention of the legislature and to interpret and determine the true scope of the provision, but only if the provision is ambiguous. *Rangaswamy v CWT 221 ITR 39*, *Govt of India v. Jagdish 221 ITR 338*, *Shankaranarayana v. State of Karnataka 239 ITR 902*.

- Where the provisions are unambiguous there is no warrant for resort to external aids of interpretation such as notes on clauses of the Finance Bill and memorandum explaining the provisions. *CIT v. Central Bank 185 ITR 6*.
Arguments for Section 115O overrides section 90(2)

- Sec 115O contains a non-obstante provision and therefore overrides all other provisions of the Act including sec 90(2). The operation of sec 90(2) is subject to section 115O. Therefore sec 90(2) will have to be applied first, followed by sec 115O
- Section 115O overrides all other provisions of the Act and it being later enactment hence it will prevail
- If section 115O overrides sec 90(2), i.e., is applied after application of sec 90(2), the benefit of lower rates of tax under the double taxation avoidance agreements India has entered into with other countries will be denied

Arguments for Section 90(2) overrides section 115O

Sec 90 aims to give effect to international fiscal agreements entered into between India and other Governments. The Constitutional mandate backing these treaties requires the provisions of the Indian tax laws to give way to the treaty law.
Sec 90(2) overrides sec 115O or vice versa?


CBDT in its Circular No. 333 dated 2-4-1982, has observed:

“The correct legal position is that where a specific provision is made in the Double Taxation Avoidance Agreement, that provision will prevail over the general provisions contained in the Income-tax Act, 1961. In fact the Double Taxation Avoidance Agreements which have been entered into by the Central Government u/s.90 of the Income-tax Act,1961, also provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country, except where provisions to the contrary have been made in the Agreement. Thus, where a Double Taxation Avoidance Agreement provided for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income-tax Act. Where there is no specific provision in the Agreement, it is the basic law, i.e., the Income-tax Act, that will govern the taxation of income.”
Other arguments for and against

**India-Hungary DTAA:**

Article 10(2) of India-Hungary DTAA pari materia to India-Mauritius DTAA

- Protocol to India-Hungary DTAA specifically provides a cap on the tax rate applicable on distributed profits; Relevant extract of protocol:

  “When the company paying the dividends is a resident of India the tax on distributed profits shall be deemed to be taxed in the hands of the shareholders and it shall not exceed 10 per cent of the gross amount of dividend”

- Date of coming into force of India-Hungary DTAA – March 4, 2005 i.e. post DDT implementation

- Planning opportunity – Hungary is an OECD member country; Possible to import MFN clause in other DTAA?

  Possible to argue that had there been a similar intent, the India Mauritius DTAA would have been modified

**Note:**

India Malaysia treaty modified in 2012 does not contain such a clause. It reflects the intent of the Government.
**Jurisprudence on the issue**

- In the case of *Volkswagen of South Africa (Pty) Ltd (High Court of South Africa)*, it was held that secondary Tax on Companies (STC) payable on distribution of dividends by a South African company cannot be restricted to the lower tax rate under the relevant DTAA. STC is a tax on company declaring dividend and not on dividend. Benefits conferred by Article 7 (Dividend) is to be enjoyed by recipient and not payer.

- **SGS India case (Mumbai Tribunal):**
  - Indian company paid DDT under domestic tax laws on dividend paid to Swiss company
  - Before CIT(A), Indian company raised the ground for refund of DDT on the basis that DDT should have been restricted to 10 percent under India-Swiss DTAA
  - CIT(A) did not adjudicate on this issue
  - Mumbai Tribunal restored the matter to the file of CIT(A) to determine admission and disposal of case on merits

- Article 10(2) of India-Swiss DTAA is *pari materia* to India-Mauritius DTAA
ARTICLE 10(2) – MEANING OF BENEFICIAL OWNER

- Beneficial owner’ not defined in Model Convention and in most Tax Treaties
  - To be understood in light of object and purpose of Tax Treaties
  - Anti-tax avoidance provision

- Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. – Para 12.1 of Article 10

- Hence, the benefit Article 10 should not be extended to an entity merely receiving the dividend. The receipt must also be beneficial owner of the dividend income.
ARTICLE 10(2) – MEANING OF BENEFICIAL OWNER

In the case of Natwest (220 ITR 377) (AAR) the AAR held that in determining ‘Beneficial Ownership’ substance has to seen over form. In this case the benefit of the DTAA was not allowed to the Mauritius Entity who held the shares on behalf of the US entity. It was held that the Mauritius Entity is a Conduit and hence, benefit of the DTAA would not be available.

Further, the AAR held that a “beneficial owner” is one who is free to decide whether or not the capital or other assets should be used or made available for use by others; or on how the yields therefrom should be used or both.

Further, the AAR held that treaty benefits should not be granted to formal title to dividends, interests or royalties but to the real title.

In the case of AIG (224 ITR 473)(AAR), the AAR held that it is a beneficiary and not a trustee who is a beneficial owner.
ARTICLE 10(3) - DEFINITION OF DIVIDEND

Dividend means income from

- Shares;
- ‘jouissance’ shares or ‘jouissance’ rights;
- mining shares;
- founders’ shares or
- other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.
### ARTICLE 10(3) - DEFINITION OF DIVIDEND

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<td>Benefit to non shareholders is deemed dividend in certain cases - concealed holding; beneficiary is ‘closely connected’ to shareholder</td>
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In India, mere issue of bonus, shares to equity shareholders or preference share does not result in dividends. This view has been upheld by the Honorable Supreme Court in the case of CIT vs. Dalmia Investment Co Ltd (52 ITR 567) (SC).

In the case of Shashibala Navintlal (54 ITR 478) (Guj) the Gujrat High Court held that redemption of bonus preference shares may result in dividends under section 2(22) of the Act.

Similarly a reduction of share capital under section 100 of the Co Act results in deemed dividend under section 2(22). However, a buy back of equity shares under section 77A of Co Act does not result in a dividend under section 2(22).

However, in the case of XYZ India (A.A.R. NO. P OF 2010), the AAR in the context of a buy back by an Indian company of its shares held by a Mauritian shareholder, held that the scheme was a “colourable device” used for avoiding payment of DDT in India. Further, the AAR ruled that the buy back would constitute deemed dividend as per section 2(22) of the Act and taxable as per Article 10 of the DTAA.
Whether deemed dividend as defined under Section 2(22)(e) of the Act can be extended to Article 10 of the Treaty

Section 2(22)(e) of the Act deals with payment by a company by way of an advance or loan.

On the other hand, Article 10(3) deals with income from shares, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

Since a loan does not amount to a corporate right, a view can be taken that deemed dividend under section 2(22)(e) cannot be extended to Article 10 of the tax treaty.
ARTICLE 10(4) – EXCLUSIONS IN CASE OF PE

Article 10(4) reads as under

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

Hence, the provisions of Paragraphs 1 and 2 not to apply if:

- Beneficial owner of dividend
- Carries on business/perform business in the source country
- Through a PE/Fixed base in that country; and
- The holding of shares/rights is effectively connected with the PE/Fixed base

Then, dividend would be taxable as ‘Business Profit’
ARTICLE 10(4) – EXCLUSIONS IN CASE OF PE

The term ‘Effectively Connected’ means the right giving rise to dividends

- Must enhance the economic strength of the PE;
- Must form part of the assets of the PE; and
- Something really connected rather than legally connected.
Article 10(5) reads as under:

“Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.”

Hence, Article 10(5) restricts the right of a country to tax dividend declared by a non resident company

It further, prevents imposition of tax on the undistributed profits of a non resident company
ARTICLE 10(5) - NO EXTRA-TERRITORIAL TAXATION

However, Article 10(5) will not operate if the dividends paid to a resident of Source Country; or

Dividends paid are effectively connected with a PE of recipient of the dividends in Source Country
Whether Country S can impose tax on dividends paid by Belgium Co. to its shareholders?

NO
Section 115BBD of the Act provides for taxation of gross dividends received by an Indian company from a specified foreign company (in which it has shareholding of 26% or more) at the rate of 15 percent if such dividend is included in the total income for the relevant FY.

The above provision was introduced as an incentive for attracting repatriation of income earned by residents from investments made abroad subject to certain conditions.

The provision has been extended to current financial year as well and hence, applicable for the AY 2014-15.
DIVIDEND – RECENT UPDATES – REMOVAL OF CASCADING EFFECT

- Section 115-O of the Act provides for taxation of distributed profits of a domestic company.

- As stated earlier Section 115BBD of Income Tax Act provides for taxation of gross dividends received by an Indian company from a specified foreign company (in which it has shareholding of 26% or more) at the rate of 15 percent.

- Further, section 115-O provides that the tax base for DDT (i.e. the dividend payable in case of a company) is to be reduced by an amount of dividend received from its subsidiary (which is also an Indian Company) if such subsidiary has paid the DDT which is payable on such dividend. This ensured removal cascading effect where dividend has been received from an Indian subsidiary.

- Similarly, Section 115-O has been amended whereby the tax on dividends received from the foreign subsidiary is paid under section 115BBD by the holding domestic company then, any dividend distributed by the holding company in the same year, to the extent of such dividends, shall not be subject to DDT under section 115-O.
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TAXATION OF INTEREST INCOME
INTEREST – TAXABILITY UNDER THE ACT

Under the Act Interest means income from

➤ According to 2(28A) of the Act “interest” means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised

➤ According to Section 2(28B) “interest on securities” means-

• interest on any security of the Central Government or a State Government;

• interest on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or Provincial Act

➤ The above definition is very wide and covers interest payable in any manner in respect of loans, debts, deposits, etc as also fees in the nature of commitment charges on unutilized portion of credit facilities.
INTEREST – TAXABILITY UNDER THE ACT

- Section 9(1)(v) of the Act reads as follows:

- Income by way of Interest payable by:
  
  a) The Government; or
  
  b) a person who is a resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or
  
  c) a person who is a non-resident, where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India;
INTEREST - OVERVIEW

- Article 11(1) – Distributive Rule
- Article 11(2) – Taxing rights of Source Country
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- Article 11(6) – Arms Length Interest Amount
ARTICLE 11(1) – DISTRIBUTIVE RULE

Article 11(1) reads as under:

“Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State”

Article 11(1) gives right to the resident country of the person receiving the interest to tax the interest income

Taxation is of interest ‘paid’ – Hence, it would be necessary to understand the meaning of the term paid.

Paid Means

Fulfillment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom

Should not be restricted to physical payment in cash as it might include performance in kind or off set of amounts

The term paid would have the same meaning as discussed in Article 10(1)
ARTICLE 11(1) – MEANING OF THE TERM ARISING

Article 11(1) deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State – Para 6 of Article 6 of the OECD Commentary.

As per Black’s Law dictionary the meaning of the word “arises” means coming into existence or notice or presents itself and conveys the idea of the growth or accumulation with a tangible shape so as to be receivable.

As per Advanced Law Lexicon dictionary the meaning of the word “arise” means to spring up, originate, to come into being or notice; to present itself.
The Supreme Court in the case of E.D. Sassoon and Co Ltd (26 ITR 27) (SC) held that the words 'accrue' and 'arise' are not defined in the Act. The ordinary dictionary meaning of these words has got to be taken as the meaning attaching to them. 'According' is synonymous with 'arising' in the sense of springing as a natural growth or result.
ARTICLE 11(2) – TAXING RIGHTS OF THE SOURCE COUNTRY

Article 11(2) read as under

“However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, **but if the beneficial owner** of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.”

Source Country can also tax the dividend subject to the threshold limit (As agreed by member the states).

Such taxation would be done at gross amounts

Pre-requisite to for Article 11(2) to apply -

- Beneficial owner is the resident of the Other State
- Limited right to tax in source country on gross basis

Source Country is free to apply its laws to levy tax either by deduction or by assessment. India taxes such interest payments to non-residents at source.
ARTICLE 11(2) – MEANING OF BENEFICIAL OWNER

- Beneficial owner’ not defined in Model Convention and in most Tax Treaties
  - To be understood in light of object and purpose of Tax Treaties, including avoiding double taxation and the prevention of fiscal evasion and avoidance

- Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. – Para 10 of Article 11

- The benefit of the treaty would not be available if the recipient of the income acts simply as conduit for another person who in fact receives the benefit of the income concerned.

- Further, the judicial precedents explained in Article 10(2) in respect of beneficial ownership would equally be applicable here.
ARTICLE 11(3) - DEFINITION OF INTEREST

Interest as defined in Article 11(3) means income from:
- every kind (secured or unsecured; participative or non participative);
- government securities;
- bonds or debentures;
- premiums and prizes attached to securities, bonds or debentures; and
- Penalty charges for late payment are specifically excluded from the definition of interest;

The above definition is an exhaustive definition.
ARTICLE 11(3) – ISSUES

- Whether interest on participating bonds and interest on convertible bonds to be considered as interest?
  - Yes, till its converted into shares (According para 19 of Article 11 of the OECD commentary)
- Whether Usance Interest falls within the definition of interest?
- The definition of ‘Usance’ as per Advanced Law Lexicon 3rd edition 2005,
  - “Usance” is the time which it is the usage of the countries, between which bills are drawn, to appoint for payment of them.”
  - The Andhra Pradesh High Court in the case of CIT Vs. Vishakapatnam Port Trust (144 ITR 146) (AP HC) held that when the payment of interest is part and parcel of the agreement to pay the unpaid purchase money on a deferred payment basis, there is no indebtedness and hence, such payments would not constitute interest payments under Article 11.
  - The Gujarat High Court in the case of CIT Vs. Vijay Ship Breaking Corporation (261 ITR 113) held that unpaid purchase price to supplier is a debt claim and any interest that is contractually charged by the supplier on such unpaid purchase price is interest.
- Whether branch can claim a deduction for interest payment to HO?

- Whether Indian Branch liable to withhold tax on interest payment to HO?
Interest paid to the HO by its India branch which constitutes its PE in India is though not deductible as expenditure under the domestic law being payment to self, the same is deductible while determining the profit attributable to the PE which is taxable in India as per the provisions of the applicable Tax Treaty;

The interest paid by the India Branch to its HO / Offshore Branches is not income chargeable to tax in India as being payment to self which cannot give rise to income that is taxable in India as per the domestic tax law.

Separately, since the income is not chargeable to tax in India, provisions of section 195 are not attracted and there being no failure to deduct tax at source from the payment of interest by the PE, the interest is held allowable as deduction for the India Branch.

Specific clause under the India-Japan and India-Belgium Tax Treaty allow for deduction of such interest payments to its HO.
SCOPE OF TOTAL INCOME OF A NON-RESIDENT – SECOND SOURCE AS PER DTC

- As per the DTC Income is deemed to accrue in India if it accrues whether directly or indirectly from
- Interest on funds borrowed by a non-resident for earning income from any source in India
- However, under the current provisions as per the Income Tax Act, the definition of Interest as per Section 9(1)(v)(c) reads as under.

  “a person who is a non-resident, where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India ;”

- Therefore, if the DTC comes into effect even the Second Source of Income would be subject to tax in India
- The consequences are explained in the subsequent slides
SCOPE OF TOTAL INCOME OF A NON-RESIDENT

Holcim Limited, Switzerland

Bank

Interest on Loan

Outside India

India

ACC Limited

Leveraged buyout of 39% stake

Loan

Interest payable by Holcim to the Bank deemed to accrue in India

IFA – Article 10 and 11
SCOPE OF TOTAL INCOME OF A NON-RESIDENT

Not only acquisition, but also transactions like ECBs / debenture with borrowed funds gets triggered.
ARTICLE 11(4) – EXCLUSIONS IN CASE OF PE

Article 11(4) reads as under

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

Hence, Provisions of Paragraphs 1 and 2 not to apply if:

- Beneficial owner of interest
- Carries on business/performs business in the source country
- Through a PE/Fixed base in that country; and
- The holding of shares/rights is effectively connected with the PE/Fixed base

Then, such interest would be taxable as ‘Business Profit’
ARTICLE 11(5) – SOURCING RULES

Article 11(5) reads as under

“Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.”

This paragraph is a deeming fiction which deems the interest to arise in a particular state as prescribed below.

Source state of the interest shall be the state of which the payer of the interest is a resident.
ARTICLE 11(5) – SOURCING RULES

The above mentioned rule has one exception which is stated as under

- If the payer of interest has PE in a contracting state; and
- the interest is actually borne by a PE of the payer in that Contracting State; then

Such contracting state has right to tax the interest borne by such PE
**ARTICLE 11(5) – SOURCING RULES**

**USA**
- Interest Payment to US Co.

**UK**
- Borrow from US Co.
  - **Lender Company (Country R – US)**
  - **Borrower Company (Country S – UK)**
  - **Branch of Borrower Company**

**India-US Tax Treaty - interest deemed to arise in India, since PE of borrower company (in country S - India), in connection with which indebtedness incurred and interest borne by PE**

Interest received by Lender Company would be taxable in India if loan is borne by PE of Borrower Company in India.
ARTICLE 11(6) – ARM’S LENGTH PRINCIPLE

Article 11(6) reads as under.

“Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention. “

Restricts the operation of Article 11 to the amount of interest determined as per arm’s length principle when special relationships exist.
ARTICLE 11(6) – ARM’S LENGTH PRINCIPLE

‘Special Relationship’ may exist

- Where the interest is paid to a person who holds direct / indirect control over the payer; and
- Where there is a relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of interest

If the Article is applied, then excess amount may be subjected to tax as per the domestic tax laws of each of the Contracting States
CAPITAL GAINS
TAX UNDER TREATY

- Capital gains tax dealt with Article 13/14
- ‘Capital gain’ or ‘alienation’ or ‘property’ not defined under DTAA
  - ‘Alienation’ defined (E.g., Mauritius, Tanzania, Sri Lanka, Bangladesh) to mean sale, exchange, transfer, relinquishment, extinguishment, compulsory acquisition.
  - Sale, exchange or transfer, ‘as defined in domestic law’ covered – E.g. Bangladesh.

- Article 13/14 does not cover the following:
  - Consideration for use of property
  - Gain on redemption of debentures/bonds.
  - Distribution on liquidation/ capital reduction to the extent of accumulated reserves
## TAX UNDER TREATY

<table>
<thead>
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<th>Capital assets</th>
<th>Taxability</th>
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<td>Immovable property (including shares</td>
<td>Taxability in the country where the immovable is situated.</td>
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<td>representing immovable Property)</td>
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<td>Movable property forming part of P.E.</td>
<td>Taxable in the country in which PE exist</td>
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<td>Ships, aircraft, boat</td>
<td>Taxable in the country of Place of Effective Management</td>
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<td>Other shares</td>
<td>Generally taxable in the source country(where company whose shares are transferred is resident). However, certain treaties provide exception such as:</td>
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<tr>
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<td>- Mauritius, Cyprus, Korea etc. provide taxation in country of residence of transferor</td>
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<td>- Singapore, Netherland etc. provide taxation in country of residence of transferor subject to fulfilment of certain conditions</td>
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<td></td>
<td>- France, Belgium etc provide for taxation in country of residence of transferor subject to threshold participation</td>
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<tr>
<td>Any other property</td>
<td>Taxability varies from treaty to treaty</td>
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</tbody>
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ARTICLE 13/14 – IMMOVABLE PROPERTY

Immovable property defined in Article 6

- Meaning as per domestic law
- Includes property accessory to immovable property, livestock and equipment used in agriculture and forestry, usufruct of immovable property, etc.
- Excludes ship, boats, aircraft

Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other contracting State may be taxed in that other State. [Generally followed in treaties and Corresponds to Article 6]

Applies to immovable property, whether business or private property.

- Supplement – Gains from alienation of shares deriving principal value from immovable property (defined in certain treaties to mean 50%) is situated in a State, taxable in that State

- Applicability to principally immovable property owning entities
ARTICLE 13/14 – MOVABLE PROPERTY OF PE

- Movable property – All property other than immovable property defined in Article 6
- Includes incorporeal property, e.g., goodwill, license, etc.
- Economic ownership of property should be allocable to PE as per attribution principles.

Gains from alienation of:
1) Movable property forming part of the business property of a PE/fixed base or;
2) PE/FB

May be taxed in that other state in which the property of the PE/FB is situated. [Generally followed in treaties]

Gains from movable property not forming part of PE not covered. Eg., gains from sale of private property.
Gains from the alienation of:

- ships or aircraft operated in international traffic,
- boats engaged in inland waterways transport or
- movable property pertaining to the operation of such ships, aircraft or boat

shall be taxable only in the Contracting State in which the POEM of the enterprise is situated

India reserves the right not to extend Article 8 to cover inland waterways transportation
**ARTICLE 13/14 – SHARES**

- Gains arising from transfer of shares are generally taxable in source country (where company whose shares are transferred is resident).
- However, certain treaties provide exceptions such as
  - Mauritius, Cyprus, Korea etc. provide taxation in country of residence of transferor
  - Singapore, Netherlands etc. provide taxation in country of residence of transferor subject to fulfillment of certain conditions
  - France, Belgium etc. provide for taxation in country of residence of transferor subject to threshold participation
ARTICLE 13/14 – ANY OTHER PROPERTY

➤ Gains from the alienation of any property, other than those discussed earlier, shall be taxable only in the Contracting State of which the alienator is a resident. (Generally followed in treaties, with or without threshold)

➤ Essentially covers capital gains from movable property or capital gains in State of residence or third States (E.g. land forming part of PE in India, situated in 3rd state)
Art. 6 – Immovable Property

- Income derived by a resident from immovable property (including income from agriculture or forestry) situated in another State may be taxed in the other State.
- Rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources are included in this Art.
Art. 6 – Immovable Property

- Domestic legislation
  - Taxed on net basis; or
  - Taxed in a different way (deemed income)
- Taxation under tax treaties
  - Taxed on net basis
  - Taxation right granted to source state
  - Relief for double taxation in residence state
“The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated”

“The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.”

“Ships, boats and aircraft shall not be regarded as immovable property.”