Taxation of Cross-Border Royalties, Interest, and Dividends: Understanding the Force of Attraction Rule and Permanent Establishments

CA Harsh Saraf

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NALSAR

Force of Attraction

Force of Attraction

IBFD International Tax Glossary

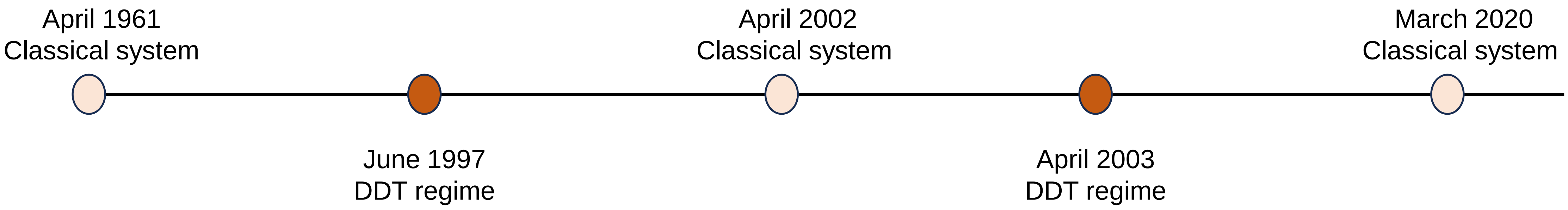
- "Principle under which a country may tax a foreign enterprise in respect of income it derives in that country if the enterprise maintains a PE there, irrespective of whether that income is derived through or otherwise economically connected with the PE"

Types of Force of Attraction

- **Full force of attraction**: All profits derived in source State taxable as profits of the PE whether or not through such PE (i.e., 100% attribution)
- **Limited force of attraction**: Profits derived through PE as well as profits from sale of goods / activities of same or similar to that of PE directly carried out by the HO in the source country taxable as profits of PE
- **No force of attraction**: Only profits derived through PE taxable

Outbound Dividend

Dividend taxation in India – Journey so far



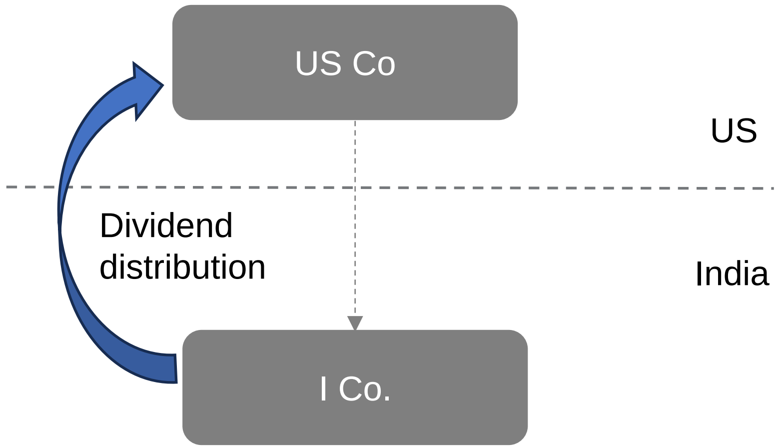
Possible rationale for abolition of DDT

- DDT regime considered as regressive
- Technological advancement and availability of tracking systems
- Availability of tax credit in home jurisdiction
- Tax litigation (eg. DDT rate vs. Tax Treaty rate)

Outbound dividend – Meaning

Outbound dividends refer

- to dividend payments
- made by a resident company in one country (say India)
- to a non-resident shareholder or parent company located in another jurisdiction. (say US)



Significance of “Outbound Dividend” in global context

- **Revenue generation** - Tax revenue for countries
- **Encourage Foreign investments** - Favorable tax treatment to attract FDI
- **Capital outflows** - To maintain financial stability and control capital outflows
- **Treaty negotiations** - To balance need for revenue & FDI
- **Prevention of Tax Avoidance & Base Erosion –** Implementation of anti-avoidance rules (like GAAR and the BEPS Action Plan) to ensure that outbound dividends are taxed fairly and profits are not artificially shifted out of the country
- **Economic Growth** - Success of foreign investments

“Outbound Dividend” vis-à-vis “Local dividend” - Few illustrations

Country	Outbound dividend*	Local dividend (for corporates) - within EU jurisdiction**
Italy	WHT ~ 26%	Zero WHT rate where the EU Parent-Subsidiary Directive 2011/96/EU is applicable**
Germany	WHT ~ 25%+	Corporate shareholders receiving dividends from other German companies generally enjoy **95% tax exemption** on dividends
France	WHT ~ 25%	Zero WHT rate**
Netherlands	WHT ~ 15%	Zero WHT rate**

*Reduced rate may apply subject to DTAA
** Subject to satisfaction of certain conditions

“Force of Attraction” language used in various DTAAs [1/2]

- **India-US tax treaty** (Article 10 extract)

*4. 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**, or performs in that other State independent personal services from a fixed base situated therein, and the **dividends are <u>attributable to</u> such permanent establishment or fixed base**. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.*

- **India-UK tax treaty** (Article 11 extract)

*4. The provisions of paragraphs 1 and 2 of this Article 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**, or performs in that other State independent personal services from a fixed base situated therein, **and the holding in respect of which the dividends are paid <u>is effectively connected with</u> such permanent establishment**. In such case the provisions of Article 7 (Business profits) or Article 15 (Independent personal services), as may be the case, shall apply.*

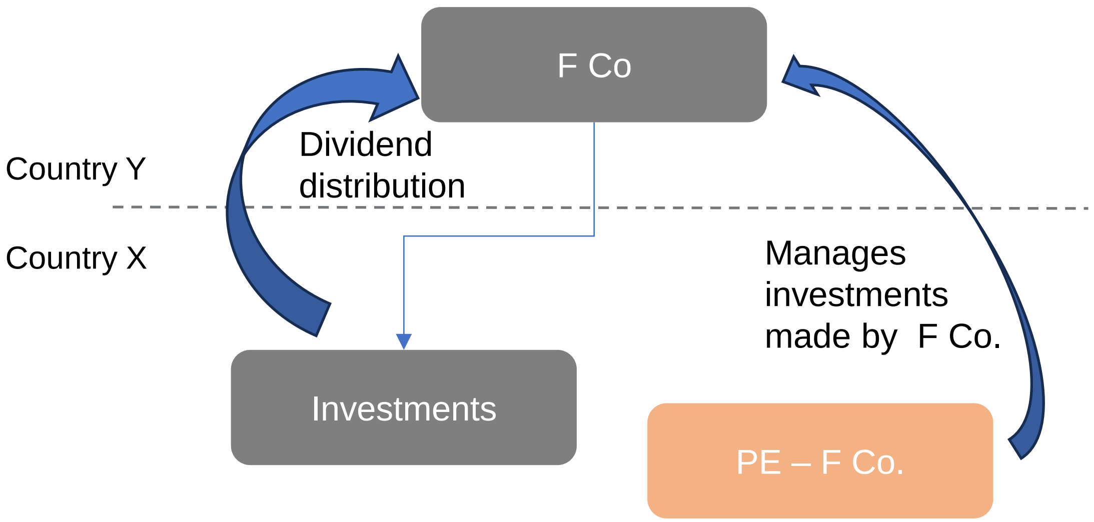
“Force of Attraction” language used in various DTAAs [1/2]

- **Germany-US tax treaty** (Article 10 extract)

*6. 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, or performs in that other State independent personal services from a fixed base situated therein, **and the <u>holding in respect of which the dividends are paid forms part of the business property</u> of such permanent establishment or fixed base**. In such a case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.*

Illustration 1

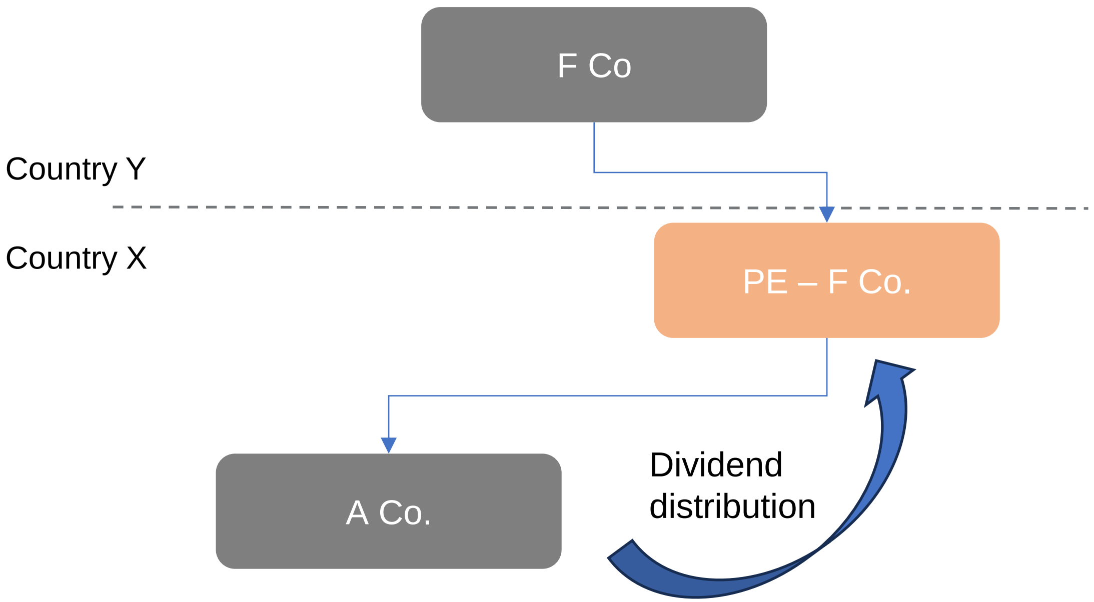
- F Co. is a tax resident of Country Y
- F Co. operates a PE in Country X
- The PE manages local investments made by F Co. in Country X
- F Co. earns dividend from such investments



Can the dividends earned by F Co. be tied to the PE's management activities? If yes, what will be the consequences ?

Illustration 2

- F Co. is a tax resident of Country Y
- F Co. operates a PE in Country X
- PE holds investments in A Co. which is in Country X
- PE provides say strategic guidance, financing, or advisory services to A Co.
- A Co. distributes dividend



How will the dividends distributed be taxed in Country X, as dividend income or business profits?

Extraterritorial taxation of dividend under Article 10(5)

Extract from the OECD MTC, 2017

- *“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 PE 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.”*

- OECD as well as UN Model Convention provide for broadly the same general rules for allocation of taxing rights between Residence and Source-States in respect of passive income from dividend (Article 10). The above rules have been adopted by India in almost all the DTAAs with other countries

India-US DTAA (Article 10 extract)

- *“(5.) 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** or a fixed base 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.”*

Article 10(5) of India-US DTAA

- Article 10(5) primarily limits the ability of the source state (say “India”) to impose taxes on dividends paid by a company that is a resident of India to say a US resident (or vice versa). It outlines specific conditions under which India can tax such dividends:

  - **Dividends Paid to a Resident of the Source State**: This part of the clause restricts India from taxing dividends unless they are paid to a resident of India. This means that if the dividends are paid to a resident of India, then India can tax them.

  - **Dividends Effectively Connected with a Permanent Establishment or Fixed Base**: India can also tax the dividends if they are paid out from holdings that are effectively connected with a Permanent Establishment (PE) or fixed base that the US company has in India.

Understanding the Treaty Provision:

- **Non-Resident Taxation**: For dividends paid to non-residents (like a US company), India's right to tax such dividends is generally limited by the treaty rate, and further restrictions apply unless the dividends are connected to a PE the US company has in India

- **No Tax on Undistributed Profits**: Importantly, Article 10(5) also mentions that India cannot tax the company’s undistributed profits, emphasizing the treaty's role in preventing extraterritorial taxation and double taxation

Article 10(5) of India-US DTAA *(contd..)*

Implications for a US Company:

- If a US company receives dividends from an Indian company and does not have a PE in India, or the dividends are not connected to any such PE:
  - The dividends are subject to withholding tax at the treaty rate (usually reduced compared to domestic rates).
  - India should not impose any additional taxes on these dividends beyond the withholding tax.
- If the US company has a PE in India and the dividends are effectively connected to this PE:
  - The dividends may be taxed at a higher rate as they could be considered business profits associated with the PE.
- In essence, Article 10(5) aims to ensure that dividends paid to non-residents are only taxed **under controlled conditions**, reflecting the treaty's objective to facilitate cross-border investment by mitigating potential double taxation and ensuring fair tax practices

Second layer of taxation

Costa Rica-Spain DTAA *(Article 10 extract)*

- *(6) Profits of a company of a Contracting State which carries out its activities in the other Contracting State through a permanent establishment located in the other Contracting State can, **after having been taxed by virtue of Article 7**, **be subjected to tax**, insofar as the remaining amount is concerned, in the Contracting State in which the permanent establishment is located and in compliance with the laws of this State, although in this case, **this tax must not exceed 5 per cent**.*

Canada-France DTAA *(Article 10 extract)*

- *8. Nothing in the Convention shall prevent a Contracting State from imposing on the earnings attributable to a permanent establishment, situated in that State, of a company which is a resident of the other Contracting State a tax in addition to the tax allowable under the other provisions of the Convention, **provided that any additional tax so imposed shall not exceed 5 per cent* of the amount of such earnings**……….For the purpose of this provision, the term "earnings" means the profits or gains after deducting therefrom the taxes, other than the additional tax referred to herein, imposed on such profits or gains by the first-mentioned State.*

Application of Extraterritorial Taxation

Brazil-Italy DTAA *(Article 10 extract)*

- *(5) Where a resident of Italy has a permanent establishment in Brazil, this permanent establishment may be subject to a tax withheld at source in accordance with Brazilian law.* ***However, such a tax cannot exceed 15 per cent of the gross amount of the profits of that permanent establishment determined after the payment of the corporate tax related to such profits.***

Austria-Canada DTAA *(Article 10 extract)*

- *5. Where a company is a resident of a Contracting State, the other Contracting State may not impose any tax on the dividends paid by the company to persons who are not residents of that other State, or subject the company to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.* ***The provisions of this paragraph shall not prevent that other State from taxing dividends relating to a holding which is effectively connected with a permanent establishment or a fixed base operated in that other State.***

Special Rule for Undistributed Dividends of a CFC

- Controlled Foreign Corporation (CFC) rules are the rules by means of which countries try to prevent the tax deferral of profits that normally would have arisen and been taxed in the relevant country.

- Article 10(5) should only apply when the country applying the CFC rules derives profits from the CFC country.

- Para 37 of Article 10(5) of the OECD Commentary provides that:

- *"37. It might be argued that where the taxpayer's country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5.* ***However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, <u>the paragraph concerns only the taxation of the company and not that of the shareholder</u>****."*

Countries with CFC rules *(illustrative)*

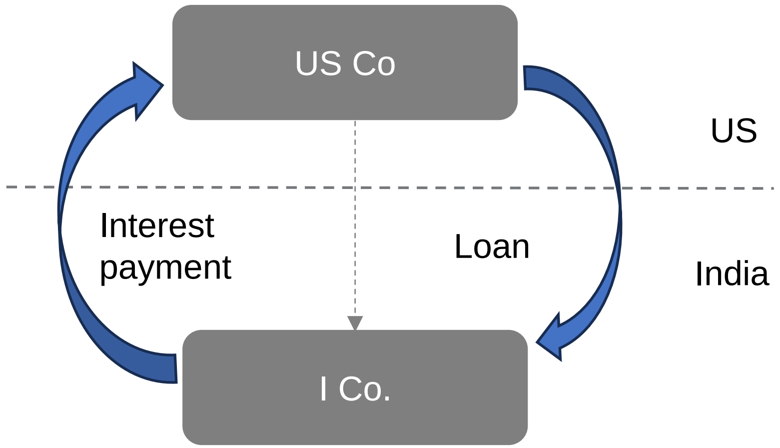
- USA : More than 10% of shares, more than 50% shares of us-citizens
- UK : Domestic management
- Germany: Domestic management, below 25% corporate tax, passive income
- France: 50% below the French tax rate
- Italy: 50% below the Italian tax rate
- China: Below 12.5% corporate tax
- Japan: Below 20% corporate tax

Outbound Interest & Royalty

Outbound interest – Overview

Outbound interest refer

- to interest payments
- made by a resident company in one country (say India)
- to a non-resident shareholder or parent company located in another jurisdiction. (say US)



General Tax Treatment:

- Countries tax outbound interest at a specific withholding tax rate
- Tax treaties may provide reduced rates or exemptions based on the relationship between the countries

Outbound interest – Indian context

Taxability and compliance in India,

- 20%++ withholding tax; reduced via DTAA (5% to 15%)
- Special rates for foreign borrowings (e.g., ECB at 5%++)
- Compliance through Form 15CA/15CB, RBI approvals, etc.
- Thin Capitalization Rule: Limits interest deduction to 30% of EBITDA for payments to associated enterprises

"Force of Attraction" language used in various DTAAs [1/2]

- **India-US tax treaty** (Article 11 extract)

5. The provisions of paragraphs 2 and 3 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, or performs in that other State independent personal services from a fixed base situated therein, ***and the interest is attributable to such permanent establishment or fixed base****. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.*

- **India-UK tax treaty** (Article 12 extract)

6. The provisions of paragraphs (1), (2) and (3)(a) of this Article 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, or performs in that other State independent personal services from a fixed base situated therein, ***and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base****. In such case the provisions of Article 7 (Business profits) or Article 15 (Independent personal services) of this Convention, as the case may be, shall apply.*

“Force of Attraction” language used in various DTAAs [2/2]

- **US-Germany tax treaty** (Article 11 extract)

3. The provisions of paragraph 1 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 through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, ***and the debt claim in respect of which, the interest is paid <u>forms part of the business property</u> of such permanent establishment or fixed base****. In such a case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.*

Effectively connected - meaning

The phrase "effectively connected" is not defined in the tax treaty or in the Act

- **Sumitomo Corpn v DCIT (110 TTJ 302) (Delhi ITAT)**

  *"60. The term "effectively connected" used in art. 12(5) of the DTAA is not to be construed as the opposite of "legally connected" but in the sense of something **"really connected"**. The **connection has to be seen not in the form but in real substance**. The income producing activity should be closely connected in terms of relationship besides being connected economically also with the PE"*

- **Worley Parsons (P) Ltd [2008] 301 ITR 54 (AAR)**

  - The PE exclusion rule applies where there is an 'effective connection' between the royalty generating services and the PE. Mere presence of PE for carrying out some other activities is not sufficient for establishing an effective connection.

  - For royalty to be effectively connected to the PE, the PE set up in a source country (viz. India) should be engaged in the performance of royalty generating services and should facilitate performance of such services.

  - Effectively connected' mean 'really connected' and the connection should not only be in 'form' but also in 'substance'. A pragmatic and purposive approach needs to be adopted and for construing whether or not an 'effective connection' exists between the PE and the royalty income. The set up, the functions, the purpose, the duration of the PE etc. are relevant factors for determining this aspect.

Effectively connected - meaning

- **Worley Parsons (P) Ltd [2008] 301 ITR 54 (AAR)** *(contd..)*

  - The words ‘effectively connected with the PE’ are not the words of redundancy and should be given their due meaning. A real and perceptible connection should exist to fulfil the said criterion.

  - For the exclusion of the PE rule to get triggered, the PE must have substantial activities and must be carried on over a period of time. A nominal establishment with skeletal staff, attending to minimal or negligible work, may not be sufficient to trigger the PE exclusion rule, on the ground of effective connection.

Illustration 1

- US Co. lends money to a company in India (say) and receives interest payments on that loan.
- US Co. also operates a branch (PE) in India, which is involved in generating leads, managing and facilitating the loan

Can the interest earned by US Co. be said to be attributable to its Indian PE?

Illustration 2

- A US-based company lends money to a company in Germany and receives interest payments on that loan.
- The US company has a PE in Germany, but the debt-claim (loan) is held directly by the US parent company and does not form part of the PE's business property.
- The loan is not listed on the PE's balance sheet
- However, PE is actively involved in generating leads, managing and facilitating the loan

Can the interest earned by US Co. be said to be considered as a part of the PE's business activities?

Renvoi Clause

- The Renvoi clause refers to the mechanism where a specific article in a tax treaty (like Article 11 for Interest or Article 12 for Royalties or Fees for Included Services) **"throws back"** to another article, typically Article 7 (Business Profits), for taxation when certain conditions are met.

- In most tax treaties, Interest (Article 11) and Fees for Included Services (Article 12) are usually treated as passive income subject to a withholding tax in the source country.

- However, if the income (such as interest or fees) is effectively connected with a Permanent Establishment (PE) in the source country, it is no longer treated as passive income. In this case, the specific articles (e.g., Article 11 for interest) defer to Article 7 (Business Profits) for taxation, meaning the income is taxed as business profits rather than being subject to withholding tax.

- This "throwback" or reference to Article 7 is referred to as the Renvoi clause.

Rulings in favour of taxpayer

DCIT v. Marubeni Corporation, Japan (ITA No.: 10/Mum/2022) (Mum)

Facts of the case:

- The taxpayer is a company incorporated in, and fiscally domiciled in, Japan
- It has various streams of income from its India operations,
  - ❑ income from its PE in India,
  - ❑ Fees from Technical Services (FTS),
  - ❑ income from shipping business and
  - ❑ income from interest on suppliers' credit apart from other incidental incomes
- During the Assessment Year (AY) 2016-17, the taxpayer received **interest from its Indian customer on suppliers' credit**
- This interest income was offered to **tax at the rate of 10% as interest under Article 11(2) of the India-Japan tax treaty**

Tax officer's contention:

- The Tax officer (AO) observed that the taxpayer **had a PE in India** and hence **interest income was taxable as business income** under Article 7 at 40%++.
- Further the taxpayer was no longer eligible for the concessional rate of gross basis taxation at 10%.
- However, the CIT(A) held that the interest income was required to be taxed at 10% in terms of the provisions of the Article 11(2) **as there was no connection between the interest income and the PE**.

Contd..

DCIT v. Marubeni Corporation, Japan (ITA No.: 10/Mum/2022) (Mum)

Ruling:

- Mere existence of a PE in the source jurisdiction cannot be reason enough to invoke the taxability of interest income under the business income Article unless such an income **is directly or indirectly attributable** to such a PE
- A **connection per se of an income** with the **PE cannot always and inevitably lead** to the attribution of such income in the hands of the PE
- **'Attribution of an income' to the PE is a degree higher than mere 'connection of an income' with the PE**
- There can be an income which may have some connection with the PE and yet the connection may not be material enough to hold that such an income was attributable to that PE
- The exclusion clause under the interest Article does not explicitly provide for taxation of such income at a rate higher than the rate prescribed under the interest Article. It provides that in a situation in which the interest is 'effectively connected' with a PE or a fixed base, the provision of business income or IPS will come into play.
- An interpretation of the exclusion clause making it meaningless will result in an interpretation contrary to the well-settled principle of interpretation *ut res magis valeat quam pereat*, i.e., to make a legal provision workable rather than redundant. This principle has been approved by the SC in the case of **Tinsukhia Electricity Supply Co Ltd**.
- The scheme of the exclusion clause does not visualise a situation in which:
    - the source jurisdiction taxability of an interest income will be ousted because of the enterprise having a PE in the source jurisdiction; and
    - such an interest income will also not be taxable under the business income article as the interest income is not attributable to the PE or under IPS Article as the interest income is not attributable to the fixed base available to the taxpayer.
- Such a no man's land between the domain of Article 11(2) vis-à-vis Article 7(1), or between Article 11(2) vis-à-vis Article 14(1) will be an apparent incongruity.

Contd..

DCIT v. Marubeni Corporation, Japan (ITA No.: 10/Mum/2022) (Mum)

Ruling:

- **Therefore, the connotations of the expression ‘effectively connected’, in respect of Article 11(6) read with Article 7(1), must be such that unless the interest income cannot be held to be ‘directly or indirectly attributable to a PE’, the taxation of such an interest income, at a rate higher than Article 11(2), does not come into play.**
- Therefore, an interest income can be said to be effectively connected with a PE or with a fixed base **only when the connection is such that it leads to taxability in the hands of the taxpayer under the business income article or IPS article**.
- To term a connection of the interest income with the PE or the fixed base, as ‘effectively connected’, one has to see whether, **by virtue of such a connection**, the interest income in question is taxable as an income attributable to the PE or the fixed base in question.
- Unless that taxability comes into play, there cannot be any overlap in the scope of Article 11 vis-à-vis Article 7 or Article 14.
- Further, unless there is such an overlap of the treaty provisions, there was no occasion for exclusion of one of the overlapping treaty provisions by Article 11(6).
- There was not even an effort, on the part of the tax department, to demonstrate the nexus between the PE and the interest income.
- **The onus of establishing the ‘effective connection’ between the debt claim with the PE was on the AO.**
- No part of interest income can be said to be directly or indirectly attributable to the Indian PE of the taxpayer. Hence, the Tribunal upheld the CIT’s conclusion that the interest income was taxable at 10 per cent under the interest Article.

ACIT vs. Clough Engineering Ltd., 138 TTJ 385 (Delhi Trib.) (SB)

Facts of the case:

- An Australian company had a PE in India for execution of oil and gas construction projects.
- During the relevant tax year, it had received interest on Indian income tax refunds.
- The Australian company claimed that the said income was taxable as per Article 11 (Interest) of the tax treaty between India and Australia.
- However the AO concluded that interest income is taxable under Article 7 read with Article 11(4) as the interest has been paid on the refund of tax deducted made from business receipts and thus connected to the business receipts.
- The CIT(A) held that since it was an admitted fact that the taxpayer was carrying on business through a PE in India, the AO was right in taxing the interest income as business income

Taxpayer's contention – The interest on tax refund has been received on tax deducted. The tax has been deducted by operation of law and therefore, the indebtedness cannot be said to rise in the course of carrying out the business, and therefore not effectively connected to the business carried out by the PE.

Revenue's contention – Though the interest has not arisen out of the business transactions, it is also fact that tax was deducted from the monies receivable in course of the business of the PE and therefore, there is direct nexus of the indebtedness with the assets of the business.

The debt arose on account of tax deducted at source and the economic ownership of the assets lies with the PE. Hence the 'asset-test' is satisfied. Furthermore, since the tax was deducted from the business receipts, even the 'activity test' stands satisfied. As both these tests are satisfied, the indebtedness is effectively connected with the PE and hence, the interest income is taxable as business profits.

Contd..

ACIT vs. Clough Engineering Ltd., 138 TTJ 385 (Delhi Trib.) (SB)

Ruling:

- The Tribunal held that the interest income was taxable in accordance with Article 11 of the tax treaty.
- The Tribunal observed that the Australian company was neither a banking company, nor engaged in money-lending business. Therefore, the interest income did not amount to 'business income'.
- The Tribunal held that even if debt is connected to the receipts of PE, it **cannot be said to be effectively connected with such receipts because the responsibility to pay tax lies on the assessee foreign company** from the final profit ascertained as on the last day of the previous year. Collection of tax at source by force of law did not establish effective connection of the indebtedness with the PE, as ultimately this was only an appropriation of profit of the assessee company
- As a consequence, Art. 7(1) of the tax treaty did not apply

Baker Hughes Singapore Pte (ITA No. 5337/Del/2018)

Facts:

- The taxpayer is a tax resident of US and received interest income on income tax refund in India in the concerned AY.
- The taxpayer was carrying on business in India through a PE
- The AO held that the income is taxable at MMR at 40%. It was argued that the interest was received in the course of the business of the PE and, therefore, there was a direct nexus of the indebtedness with the assets of the business

Ruling:

- Interest income need not be necessarily business income in nature for establishing the effective connection with the PE because that would render provision contained in paragraph 4 of Article 11 redundant.
- Thus, there may be cases where interest may be taxable under the Act under the residuary head and yet be effectively connected with the PE.
- The bank interest in this case is an example of effective connection between the PE and the income as the indebtedness is closely connected with the funds of the PE .
- The Tribunal went thought India-US tax treaty and concluded that interest on income tax refund is not effectively connected with the PE either on the basis of asset-test or activity-test

Rulings against the taxpayer

B. J. Service Company Middle East Limited (ITA No. 01 of 2010)

Facts of the case:

- The taxpayer, a non-resident company, is engaged in business of oil exploration
- The taxpayer received interest on income-tax refund, and computed tax on such refund at 15% as per Article 12 of India-UK tax treaty
- The Tax officer (AO) treated such interest as business income and assessed that under Article 12(6) of the tax treaty as taxpayer was having a PE in India.
- The same was upheld by CIT(A) and Tribunal

Uttarakhand HC ruling:

- HC ruled that the same shall be taxed as business income since the debt-claim in respect of which interest is paid is effectively connected with a PE in India.

Interest arising from banking business

Section 9(1)(v)

- The CBDT, in its Circular No. 740 dated 17/4/1996 had clarified that branch of a foreign company in India is a separate entity for the purpose of taxation under the Act and accordingly TDS provisions would apply along with separate taxation of interest paid to head office or other branches of the non-resident, which would be chargeable to tax in India.

- However, some of the judicial rulings in this context have held that although under the provisions of the Income-tax law the payment of interest by the branch to head office is non-deductible under domestic law being payment to the self, however, such interest is deductible due to computation mechanism provided under the DTAA but it is not taxable in the hands of the Bank being income generated from self.

- The Special Bench of the Mumbai ITAT in the case of **Sumitomo Mitsui Banking Corporation [136 ITD- 66 TBOM]** had mentioned that there are instances of other countries providing for specific provisions in their domestic law which allows for the taxability of interest paid by a permanent establishment to its head office and other branches and had pointed out absence of such a specific provision in the Income-tax Act

- This position is also recognized in some of our DTAAs in particular the Indo-USA DTAA in Article 14 (3) reads as under:

  "In the case of a banking company which is resident of the United States, the interest paid by the permanent establishment of such a company in India to the head office may be subject in India to tax in addition to the tax imposable under the other provisions of this Convention at a rate which shall not exceed the rate specified in paragraph 2(a) of Article 11 (Interest)"

Contd..

Section 9(1)(v)

- **Explanation to Section 9(1)(v) [introduced with effect from 01 April 2016]**

Explanation.—For the purposes of this clause,—

(a) it is hereby declared that in the case of a non-resident, being a person engaged in the business of banking, any interest payable by the permanent establishment in India of such non-resident to the head office or any permanent establishment or any other part of such non-resident outside India shall be deemed to accrue or arise in India and shall be chargeable to tax in addition to any income attributable to the permanent establishment in India and the permanent establishment in India shall be deemed to be a person separate and independent of the non-resident person of which it is a permanent establishment and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery shall apply accordingly;

BNP Paribas (ITA No.3416/Mum/2023)

Facts:

- The taxpayer is a commercial bank having its head office in France
- The taxpayer has eight branches in India which constituted PE in India
- The BO paid interest to the overseas HO and claimed a deduction of the interest paid while computing business profit under the treaty
- The taxpayer (HO) did not recognize such interest as income taxable in India on ground that the transaction is in the nature of payment to the self.
- The taxpayer contended that the interest was paid in respect of the debt-claim which was effectively connected to the taxpayer's PE and thus, was outside the scope of the interest article
- The India-US tax treaty contains specific provision to tax the interest payable by a branch to its HO. In the absence of similar provisions in India-France DTAA, the interest is not taxable in the hands of the HO.

Revenue's contention:

- The interest article does not specifically refers to that interest paid is by a resident of India.
- The debt on which interest was paid was not effectively connected with the PE. It was connected to the HO. Hence, the business profit article was not applicable.

Contd..

BNP Paribas (ITA No.3416/Mum/2023)

Ruling:

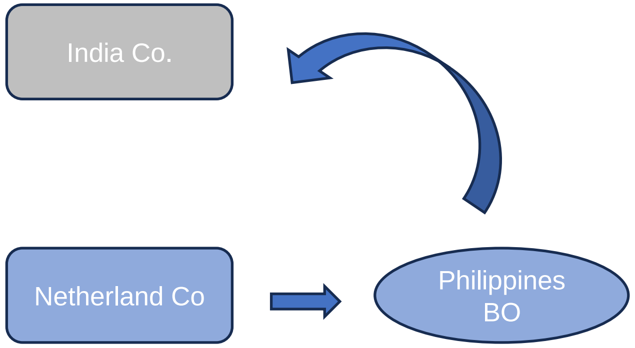
- The Tribunal ruled that though the interest paid the PE to the HO is taxable under the Act by virtue of specific provisions, such interest is not taxable under the interest article of the treaty in the absence of a similar specific provision.
- The debt claim means some money due from another person to another. In the instant case, the PE has borrowed money from the HO and thus, the debt on which interest was paid was connected to the PE.
- The interest income of the HO can be taxed under the interest article only when the HO does not have a PE in India.
- However, in the instant case, the taxpayer had a PE in India and hence, only business profit article would apply to deal with the taxability of profit attributable to the PE

Triangular situation

Shell Technology India P Ltd, 345 ITR 206

Facts:

- In the said case, an Indian company entered into an agreement with the branch office of a Netherland company which was based in Philippines, for services
- In consideration for the services, the Indian company agreed to make payment to the Philippines branch of the Dutch company on a monthly operation fee basis.
- The Indian company took the matter to AAR to decide whether the payment made by the Indian company would fall in the category of "fee for technical services" in terms of Article 12 of India-Netherlands tax treaty.
- It may be clarified that the real issue for consideration by AAR was whether the India-Netherlands tax treaty would be applicable or whether India-Philippines treaty will be applicable.
  - ❑ If India-Netherlands treaty applies then the amount paid by the Indian company to the foreign company would not be taxable in India because of the concept of 'make available' prevailing in that treaty.
  - ❑ On the other hand, if India-Philippines tax treaty applies, the amount paid by the Indian company would be taxable in the hands of foreign company because the concept of 'make available' does not exist in India-Philippines tax treaty



Ruling:

- The Authority ruled that it is the India-Netherlands treaty that will apply because "since the services are rendered by the Netherland company though through its branch in Philippines, the DTAA between India and Philippines would not be applicable".

Other provisions of Article 11

Extraterritorial taxation of interest under Article 11(5)

Extract from the OECD MTC, 2017

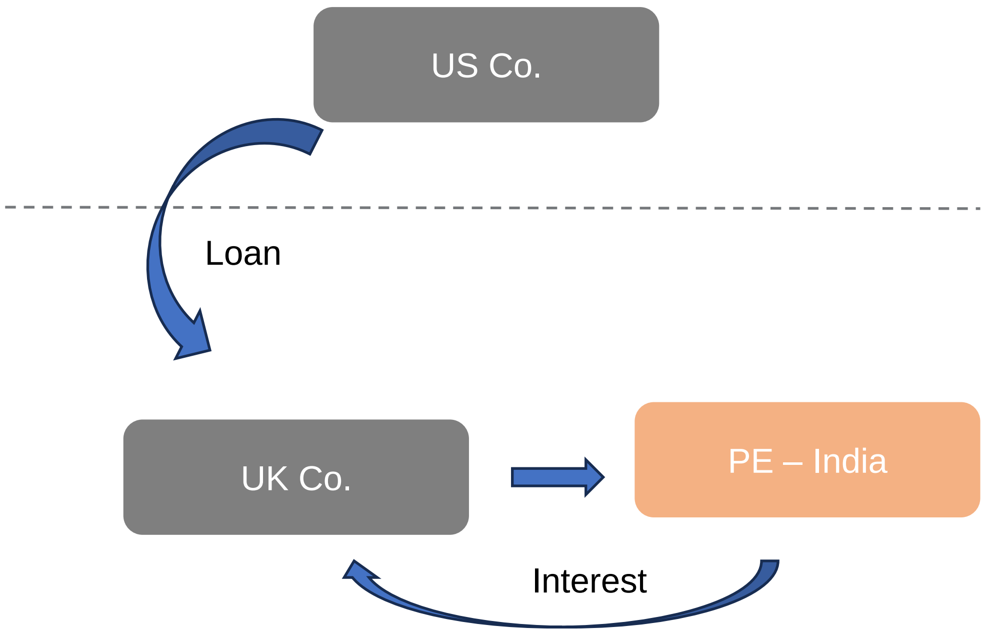
- *“Interest shall be deemed to arise in a contracting state when the payer is a resident of that state. Where, however, the person paying the interest, whether he is a resident of a contracting state or not, has in a contracting state a permanent establishment in connection with which the indebtedness 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”*

- Many bilateral tax treaties that follow the OECD Model have incorporated this clause. Eg. India-Singapore DTAA has a similar clause in Interest Article

  5. Interest shall be deemed to arise in a Contracting State when the payer is that Contracting State itself, a political sub-division, a local authority, a statutory body or 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 Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

Illustration

- UK Co. which has taken loan from a US Co.
- UK Co. has a PE in India.
- The loan taken from US Co. is for the PE in India.
- Interest is paid by the UK Co. to the US Co. is ultimately borne by the PE in India.
- Therefore, in such a case, the interest arises in the state in which the PE is located i.e. India.



- If the PE borrows – Interest clearly arises in Source Country and is taxable.
- If HO borrows specifically for the PE, funds are used for business of PE and interest is borne by the PE - It is taxable in Source Country.
- If HO borrows generally for all its worldwide PEs and subsidiaries. Some indirect interest cost is attributable to the PE - It may not arise in Source Country. Article 11 should not apply.

Arm’s length principle under Article 11(6)

Extract from the OECD MTC, 2017

- *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.*

To illustrate:

- I Co. pays interest at 15% to a related party in foreign jurisdiction
- I Co. pays interest at 10% to an unrelated company in the same foreign jurisdiction
- Therefore, the excess 5% interest could be scrutinized in I Co.’s jurisdiction.
- The exact nature of excess amount has to be determined in order to categorize such income as “dividend” or “other income” under the domestic laws.
- Possibly Article 7, 10 or 21 of the relevant tax treaty may apply.

Outbound royalty – Indian context

Taxability and compliance in India,

- 10%++ withholding tax; reduced via DTAA (10% or lower)
- Taxed on gross basis
- Compliance through Form 15CA/15CB, etc.
- Effective connection to a PE

Iveco Spa (ITA No. 5447/Del/2010)

Facts:

- The taxpayer, resident of Italy, had set up an Indian Branch Office (BO) in India.
- The taxpayer entered into a technical collaboration and license agreement (agreement) with A Limited (licensee) for providing the right to assemble diesel engines and their parts in India. Under this agreement, it received royalty income in India.
- The taxpayer had filed its return of income declaring income comprising of business income, and royalty taxable on gross basis as per Article 13 of the India-Italy DTAA
- The AO took the view that the royalty income was “effectively connected” to the taxpayer’s PE in India, and therefore chargeable as business income taxable at 41.82%.
- The DRP observed that since the taxpayer had not established that any employee from the HO had visited India for imparting assistance and training, the royalty income was effectively connected with the PE, i.e., the taxpayer’s BO in India.

Taxpayers’ contention

- The taxpayer’s BO was engaged in providing business development assistance in purchase activities, and after-sales support services to the HO. The BO was not equipped, or in any manner engaged in providing rights, to assemble diesel engines to manufacture original equipment.
- The taxpayer relied on the Delhi HC decision in **Sumitomo Corporation [ITA NO. 714/2014]** to contend that only profits economically attributable to the PE were chargeable to tax as the taxpayer’s business income under Article 12(5) of the tax treaty.
- In substance, the taxpayer contended that the BO was not at all engaged in any activities for performance of the licensee’s agreement, and therefore, the income was not “effectively connected” with the BO. Hence, it had rightly offered the royalty income to tax on gross basis.

Contd..

Iveco Spa (ITA No. 5447/Del/2010)

Ruling:

- The Tribunal analysed various articles of the tax treaty, and observed that according to article 13(5) of the tax treaty, if the right, property or contract in respect of which royalty was earned was effectively connected with the PE of the taxpayer, then the taxpayer lost the concessional treatment provided in clauses (1) & (2) of Article 13.
- Tribunal noted that three employees visited India from Italy and provided the needful support and training to the licensee. All these employees of the taxpayer were in India for execution of the agreement for technical services, and none of them stayed in India for more than 90 days.
- The Tribunal rejected the Revenue's contention that these sophisticated technical services could not be provided in the absence of support of the BO employees. To reach this conclusion, the Tribunal held that the **Revenue had not brought anything on record** about whether any actual service had been provided to the licensee. Further, the **Revenue had also not undertaken any inquiry about the nature of services** provided and the details of persons providing such services. From this, the Tribunal concluded that **merely having some technically qualified employees in the BO did not prove that the BO had provided services for the performance of the impugned contract**.
- The Tribunal stated that to effectively connect royalty and FTS income with a PE, **one had to evaluate the "asset test" and "activity test"/ "function test" respectively**.
- In this case, the asset test failed miserably. The Tribunal further mentioned that to establish the effective connection of the royalty income with the PE, (a) the PE should have been engaged in performance of technical services, or been involved in the actual rendering of such services, or (b) it should arise as a result of the activities of the PE, or (c) the PE should, at least, facilitate, assist or aid in the performance of such services, irrespective of the other activities the PE performed.
- In substance, the Tribunal held that **neither was there any material on record** about the requirement for the services by the recipient of the services, nor **any provision of such services by the BO employees**. Therefore, it could not be said that the royalty income arose out of the results of the PE's activities.

Other case studies

Set Satellite (Singapore) Pte. Ltd. (ITA No.1676 of 2011 Bom HC)

- Royalty income not taxable in India since there is no link between payment of Royalties and taxpayer’s PE in India

Tech Mahindra Limited v Commissioner of Taxation [2016] FCAFC 130

- TML had a permanent establishment (PE) in Australia. TML provided services to Australian customers both from its Australian PE and from India. The issue was whether any “royalties” paid by Australian customers to the taxpayer in India were subject to royalty withholding tax.
- It was an admitted position that the profits referable to the Indian services were not attributable to the permanent establishment in Australia under Article 7(1)(a).
- The Full Bench of Australian Court while opining that Indian Services constituted ‘royalty’ held that the ‘permanent establishment exception’ given in royalty article will apply only where such passive income is attributable to the permanent establishment
- The Court considered the language in the DTAA having regard to the purpose of the DTAA, including how the DTAA allocated taxing rights to income among Australia and India. The Court concluded that Article 12(4) is intended to give priority to Article 7 (business profits). Article 12(4) was not intended to remove Australia’s right to tax the royalty altogether, but rather to determine whether the royalty should be taxed as a royalty (subject to withholding tax) or as part of the profits of the PE.
- Accordingly, Article 12 applied to the taxpayer, and royalty withholding tax was imposed on the royalties paid by Australian customers to the taxpayer

Q&A?

Thank You

The contents mentioned in the slide is only for training purposes and should not be considered as an advice or opinion