TAXES OUTSIDE THE SCOPE OF TAX TREATIES

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Background

What is the relevance of this question?

Which taxes fall outside the scope of tax treaties

What is the starting point for the analysis of whether a tax forms part of a tax treaty?

Categories being considered in this session: cesses, surcharges, DDT, equalization levy

ARTICLE 2, OECD MC

1. This Convention shall apply to **taxes on income** and **on capital** imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on **total income**, on total capital, or on **elements of income** or of capital, **including taxes on gains from the alienation** of movable or immovable property, **taxes on the total amounts of wages** or salaries paid by enterprises, as well as **taxes on capital appreciation**.

ARTICLE 2, OECD MC

3. The **existing taxes** to which the Convention shall apply are **in particular**:

a) (in State A): ……………………………

b) (in State B): ……………………………

Is this list exhaustive / non-exhaustive?

4. The Convention shall apply also to any **identical or substantially similar taxes** that are imposed **after** the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

Article 2(1) and 2(2)

- Why does the article say taxes on income and taxes on capital?

- Historical background
- Is there a definition for taxes on income/taxes on capital?
- Taxes on “total income” and taxes on “elements of income”
- Three particular taxes are included within Article 2(2) (deemed to be taxes covered)

Rationale for taxes mentioned in Article 2(2)

Capital gains taxes: to clarify treaty coverage irrespective of notion of taxable income in national legislations

Capital appreciation taxes:

- Levied in war time or due to devaluation of currency
- Appreciation unrealized unlike in capital gains taxes
- *"taxation of such capital appreciation does not give rise to serious problems which could not be solved **but by express provision**"* (WP 19)

Rationale for taxes mentioned in Article 2(2)

Payroll taxes

- Feb 1957, OEEC, Fiscal Committee: "*draft should cover*"
- Last tax to be added: "*finally…extends to*" (OECD Comm)
- Ultimate retention: may have been done to ensure coverage without leaving it to discretion and negotiations

- *Ismer* and *Blank*: "*special cases*" – history provides insight into rationale and context of the three taxes

Taxes on income as taxes on "*total income*" and on "*elements of income*"

- Joint definition – is it even a definition?

- "*elements of income*"

➢ Ordinary meaning: part of something – tax on one or more types /sources of income

➢ **Does not refer to different components that make up income**

➢ WP 30: example of a special tax on interest income

➢ "*elements of income*" adopted to include impersonal tax systems while "*total income*" addresses personal taxes

Illustrative or exhaustive reference to payroll taxes in Article 2(2)?

- Capital gains tax

➢Tax on income - gain taxed is an accretion of the value of asset over a period of time

- Capital appreciation tax

➢Tax on income - gains are unrealized but appreciation indicates accretion in value over a period of time

- Payroll tax

➢Tax on employer's income? – flawed assumption

Identifying "*taxes on income*"

- Tax base
- Taxes on income : focus is the tax base

- Tax subject
- Recipient of income
- "*paid to*", "*derived by*" and "*attributable to*" occurring in the OECD MC
- Payroll tax is imposed on the employer who is not the recipient of income but the person undertaking the expenditure

Trends on Article 2(1) and 2(2)

- Treaty trends – Article 2(1) and 2(2)

➢ WP 30 – paras fulfil a "*good and reasonable function*"

➢ Para 6.1, OECD Commentary – alternative approach

➢ Adoption trend – USA, UK, Australia and Japan

- Definition of taxes on income - balancing act of achieving precise nomenclature widely acceptable to all countries

CESSES & SURCHARGES

Are cesses covered by tax treaties?

- Cess: whether a tax or a fee?

- "*imposed on behalf of a Contracting State*"

- "*Contracting State, political subdivisions or local authorities*"? – Union, State and local cesses – which are covered?

- Cess: existing or subsequent tax?

Are cesses covered by tax treaties?

- Historical Deliberations
- ➢ "*immaterial for which purpose this tax is collected*"

- Two instances for retaining Article 2(1), 2(2)
- ➢ Contracting State earmarking a tax subsequently
- ➢ Contracting State introducing an earmarked tax subsequently

Are cesses covered by tax treaties?

- Article 2(1) and 2(2) : asks whether cess is a tax on income / on capital
- Article 2(3) : check the list of taxes covered – is the cess mentioned (only possible if it is an existing tax)

➢ India – Poland treaty list mentions cesses

- Article 2(4): subsequent taxes: whether, identical or substantially similar – how should one judge similarity? Is purpose relevant here?

Are cesses covered by tax treaties?

Education cess was imposed by Section 91 of the Finance Act, 2010 which stipulated that "*there shall be levied and collected, in accordance with the provisions of the Chapter as a surcharge for purposes of the Union, a cess to be called the Education Cess, to fulfil the commitment of the Government to provide and finance universalised quality basic education.*"

Are cesses covered by tax treaties?

Indian education cess (Dic Asia Pacific Pte Limited v. ADIT)

- ➢Relevant treaty has an exhaustive list of taxes covered, no Art.2(1)/2(2)
- *"income-tax including any surcharge thereon"*
- Indo-Singapore DTAA was signed in 1994, but education cess was introduced in 2004
- ➢ Ruling: Covered in tax treaty because education cess is a surcharge
- ➢ substantial similarity test – passing reference

Are surcharges covered by tax treaties?

- What is a surcharge?
- Is it covered by tax treaties?
- Typically, you find the answer in Article 2(3) equivalent in Indian treaties

DDT

Dividend Taxation

- Domestic law: DDT was levied under Section 115-O of the Act :

Notwithstanding,….any amount **declared, distributed or paid** by a **domestic company** (whether interim or otherwise, paid out of current or accumulated profits) on or after April 1, 2003 but before March 31, 2020 is subject to an **additional income-tax**…

- Dividends are exempt in the hands of **resident** shareholders under Section 10(34)
- DDT applied to both, resident and non-resident shareholders of a domestic company

Dividend Taxation

❖ Reason cited for doing away with DDT in 2020

➢ Technological advancements

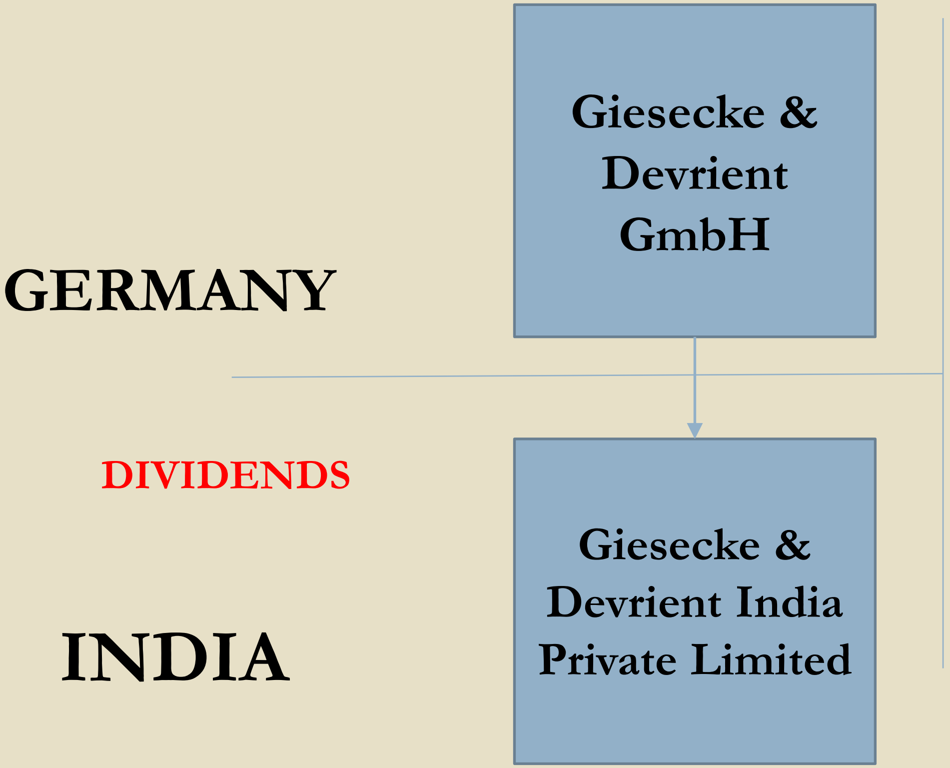
➢ International concerns re investors not getting treaty relief

➢ International tax angle: domestic companies paid DDT also on dividends paid to non-resident shareholders

➢ Non-resident shareholders sought to argue that deduction should occur at tax treaty negotiated rate (typically lower than DDT)

➢ This needed determination of whether DDT is a tax on shareholder – beneficial rate is on *dividend income in the hands of shareholders*

GIESECKE & DEVRIENT [INDIA] PVT LTD. V. THE ADDITIONAL COMMISSIONER OF INCOME TAX, ITA NO. 7075/DEL/2017



G&D India had distributed dividends to its parent for which it paid DDT.

G&D India argues that dividend should be subject to tax treaty rate of 10% (Article 10(2)) + refund of excess taxes.

India – Germany DTC notified on November 29, 1996 whereas the DDT was added through Finance Bill, 1997.

Dividend Taxation

- The DTC was notified on 29 November 1996 whereas the DDT was imposed in 1997.
- Article 2 of the DTC contains Article 2(1) and 2(2) that cover taxes on income and on capital, has a non-exhaustive list of existing taxes covered, and applies to any identical or substantially similar taxes introduced after the date of signature in addition to, or in place of, the existing taxes.
- Under Article 10(2) of the DTC, source state taxation of dividends is capped at 10% of the gross amount of dividends if the recipient is the beneficial owner of the dividends. Article 10(2) has a clarifying line which states that "this paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid"

Dividend Taxation

India-Germany Double Taxation Avoidance Agreement (Article 10)

1. 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.**

2. 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 tax so charged **shall not exceed 10 per cent** …

GIESECKE & DEVRIENT [INDIA] PVT LTD. V. THE ADDITIONAL COMMISSIONER OF INCOME TAX, ITA NO. 7075/DEL/2017

Nature of DDT: Tribunal held it to be a tax on income of the shareholder and not a tax on the company's profits

- Why did Tribunal decide nature of DDT?

Article 10(2) does not specify in whose hands dividends must be taxed

OECD Commentary states that lower rates in Article 10(2) applies "**solely to taxation of dividends and not to taxation of the profits of the company paying the dividends**"

- Indian government has consistently mentioned that the DDT is a final tax on the company – not a tax on the shareholder
- **Economic Double Taxation** (double taxation in the hands of different taxpayers) v. **Juridical Double Taxation** (double taxation in the hands of the same person)

How would you apply Article 2 here?

- **Two step analysis**: tax on income? on shareholder?
  - Tribunal did not interpret Article 2(1) & 2(2) or Article 2(4)
  - Merely because DDT was part of Act not covered by DTC
  - **Tax base**: akin to fringe benefit tax - Article 2(2), DTC (payroll tax)
  - **Tax subject**: budgetary docs say incidence *should* be on shareholder
  - **Taxable event**: transaction of dividend distribution
  - **Attributes**: final tax on company + independent of corp. income tax
- **International experience** - *Volkswagen of South Africa (Pty) Ltd v. Commr.* (70 SATC 195) held that Secondary Tax on Companies was not subject to limits under South Africa - Germany DTC

EQUALIZATION LEVY

Equalization Levy

- "The Equalization Levy imposed on the payment for digital transactions, would not be a tax on income, and hence would not be covered by tax treaties. As Equalization Levy is not proposed as tax on income, it would need to be imposed outside the Income-tax Act, 1961.

- "The word 'equalization' represents the objective of ensuring tax neutrality between different businesses conducted through differing business models or residing within or outside the taxing jurisdiction."

Equalization Levy

(a) Sum received or receivable by a non-resident for online advertisement services

- Equalisation levy is charged at the rate of 6% from the consideration paid or payable for the services in the nature of online advertisement, provision for digital advertising space, any other facility or service for the purpose of online advertisement.

(b) Sum received or receivable for e-commerce supply of goods or services made or facilitated on or after 01-04-2020

- Equalisation levy is charged at the rate of 2% from the consideration received or receivable for the e-commerce supply or services made or facilitated on or after 01-04-2020 by an e-commerce operator.

Equalization Levy

- Article 2(3) may not come to rescue – why?
- Use Article 2(1) and 2(2) tests + Article 2(4) test
- ➢ Is it a tax on total income / elements of income?
- ➢ Is it a direct tax / indirect tax?
- ➢ Contrast Article 2 with other articles (24, 26, 27) which use the phrase "taxes of every kind and description"