NALSAR University of Law

Centre for Tax Laws

Extra Territorial Operation of Income Tax Law

Treaty Override

By: **Amit Thapar**

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Agenda

- Extra Territoriality
  - Meaning
  - Parliament’s Power of Legislation
  - Source Rule
  - Accrues and deemed accrual in India
- Treaty Override
  - International vs. Domestic Law
  - OECD Treaty Override Report
  - Instances of Treaty Over-ride: Int’l and domestic
  - Validity

Territoriality

- Sec. 1(2): Scope of the Act
  - It extends to the whole of India.

Territoriality

- And ‘India’ means [Sec. 2(25A)]
  - The **territory** of India as referred to in Art. 1 of the Constitution
  - Its territorial **waters**, seabed and subsoil underlying such waters, continental shelf, EEZ or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone & other Maritime Zones Act, 1976
  - **Air space** above its territory and territorial waters

Territoriality

- How to define territoriality
  - Geographical boundaries
  - Persons resident in India
  - Indians
- Can the Parliament **legislate** the Act to apply outside the Geographical boundaries of India, or to NRs, or to persons who are not ‘Indians’

Extra Territoriality

- Source rule and Expl. to sec. 9:

For the removal of doubts, it is hereby declared that for the purposes of this section, income of a NR shall be **deemed to accrue or arise in India** under sec. 9(1)(v) or (vi) or (vii), and shall be included in the T.I. of the NR, whether or not,—

- the NR has a **residence** or **place of business** or **business connection** in India; or
- the NR has **rendered services in India**

Extra Territoriality

- WHT by a NR - Expl. 2 to sec. 195:

  WHT obligation under sec. 195(1) applies and extends, and shall be deemed to have always applied and extended even to a NR, whether or not the NR has —

  – A **residence** or **place of business** or **business connection** in India; or

  – **Any other presence in any manner whatsoever** in India

Parliament's Power of Legislation

- Art. 245. Extent of laws made by Parliament and by Legislatures of States

  (1) Subject to the provisions of this Constitution, Parliament may make laws ***for*** *the whole / any part of* ***the territory of India****, and the Legislature of a State may make laws for the whole / any part of the State*

  (2) No law made by Parliament shall be deemed to be invalid on the ground that it would have ***extraterritorial operation***

Parliament’s Power of Legislation

- GVK Industries (SC) 2011

  *The Parliament is constitutionally **restricted** from enacting legislation with respect to extra-territorial aspects or causes that **do not have**, nor expected to have **any** direct or indirect, tangible or intangible **impact on / effect in / consequences for**:*

  – The **territory** of India / any part of India; or

  – The interests of / welfare of / wellbeing of / security of **inhabitants of India**, and **Indians**

Parliament's Power of Legislation

› GVK Industries (SC) 2011

***Aspects or causes**: Events, **things**, phenomena (howsoever commonplace they may be), resources, **actions** or **transactions**, and the like, in the social, political, **economic**, cultural, biological, environmental or physical spheres, that occur, arise, exist or may be expected to do so, naturally or **on account of some human agency**.*

Extra-territorial aspects or causes**: Aspects or causes that occur, **arise, or exist**, or may be expected to do so, **outside the territory of India.

Parliament's Power of Legislation

› GVK Industries (SC) 2011

– *Any laws enacted by Parliament with respect to extra-territorial aspects or causes which have "**no impact on** or **nexus with** India" would be ultra vires Article 245 of the Constitution of India*

Equalization Levy

› India's response to S.301 Report of US

- EL has no extra-territorial application, since it is based on **sales occurring in the territory of India** through digital means

- It does not have extra territorial application as it applies only on the **revenue generated from India**

Taxation of NRs

- Total income ('TI') means income referred to in Sec. 5 of the Act

- TI of NR shall include:
  - Income received in India by or on behalf of NR
  - Income **deemed to be received** in India
  - Income accruing or arising to NR in India
  - Income **deemed to be accruing / arising** in India

Income that accrues / arises in India

- *'Accrue' or 'Arise':* Not defined
- Broad principles: Where does income accrue / arise
  - Services: Where **services** are rendered
  - Goods: Where **transfer of title** takes place

Income that accrues / arises in India

- Performing Right Society Ltd (SC)
  - Although society was NR and received income out of an agreement that was executed in UK, income undoubtedly accrued / arose in India as it was **for use of music rights in India**
  - Whether an income accrued / arose in India, is a question of **fact** which should be examined and decided upon in light of **common sense and plain thinking**

Deemed to accrue / arise in India

	Description	
Sec. 9(1) Cl. (i)	Income arising directly / indirectly • through / from any **Business Connection** (BC) in India • through / from any **property, asset, source** of income in India • through transfer of **capital asset** situated in India	
(ii)	**Salary** for services rendered in India	
(iii)	**Salary** paid by Govt. to Indian citizen for services outside India	
(iv)	**Dividend** paid by Indian Co. outside India	
(v)	Interest	Paid by Govt. or resident (unless for a business or income source outside India)
(vi)	Royalties	
(vii)	FTS	
(viii)	Receipts of money, taxable under sec. **56(2)(x)**	

Business Connection

- Income earned by a NR through / from a BC in India, is taxable in India
- BC: Not exhaustively defined
  - Inclusive **definition** in the Act (similar to **Agency PE**)
  - Meaning also derived from **judicial precedent**
  - Meaning depends on **facts** of each case

Business Connection

- BC: Definition in the Act

  BC includes any business activity carried out through **a dependent agent** who, acting on behalf of NR

  – Option 1: **Contract conclusion**

    (Scope expanded in pursuance to BEPS AP 7 report)

  – Option 2: Maintenance of **stock** to **deliver**

  – Option 3: **Securing of orders**

Business Connection

› BC: Definition in the Act

Includes 'Significant Economic Presence' (SEP), w.e.f. FY 2021-22:

– **Any transaction** in respect of any goods / services / property carried out by NR ~~in India~~ with any person in India *including provision of download of data or software in India*, **if aggregate** of payments arising from such transaction(s) during year **exceeds a prescribed amount** (INR 20 mn.); or

Business Connection

- BC: Definition in the Act (SEP)
  - Systematic, continuous **soliciting** of business **activities** or **engaging in interaction** with prescribed number of **users** ~~in India through digital means~~ (3 Lac users)

Business Connection

- BC: Definition in the Act (SEP)

  1st proviso: The transactions / activities shall constitute SEP in India, **whether or not:**

  - **Agreement** is entered in India
  - The NR has a **residence** / place of business in India
  - The NR **renders services** in India

Business Connection

- R.D. Agarwal and Co. (SC): BC involves
  - **Real and close relation** between a business carried on by NR which yields profits or gains **and some activity in taxable territories** which contributes directly or indirectly to earning of those profits or gains
  - Element of **continuity** between business of NR and activity in taxable territories
  - **Isolated transaction** not normally regarded as BC

Business Connection

- Other judicial precedents
  - G V K Industries (SC)
  - Anglo French Textile Co. Ltd. (SC)

Through / from any property or source

- Income **through or from** any **property** or **source** in India shall be taxable in hands of NR

- Property - both **tangible** and **intangible**

- '**Source** of income' - Not defined in the Act. In simple terms, it is a source **from which an income gets generated** / **from which it arises**

Source

- **Vodafone (SC) [Source of income is where the transaction takes place and not where the item of value is situated]**
- Retrospective amendments made by FA2012, to **nullify Vodafone (SC)**

Source

- Person paying income
- Economic activity
- Business unit – ***Lady Kanchanbai (SC)***
- An asset
- An event / act – ***Performing Rights Society (SC)***

Salary Income

- Salary for **services rendered** by NR **in India** is deemed to accrue in India – Irrespective of place of payment.
- Includes income payable for **leave period**
  - **Preceded** and **succeeded by services rendered in India** and
  - Which forms part of **employment contract**
- Salary paid by **Indian Government** to an **Indian citizen** for services rendered **outside India.**

Dividend income

- Dividend **paid by an Indian Co.** outside India (to NR shareholder) is deemed to accrue / arise in India.

Interest income

- Interest income earned is taxable in India, if it is **payable by:**
  - The Government
  - Resident… **Except**, if payable in respect of debt incurred / money borrowed for purposes of
    - Foreign Business
    - Foreign Income
  - **NR**, in respect of debt incurred / money borrowed for carrying on business or profession **in India**

Royalty / FTS

- Fundamental principle of deemed accrual – Same as in case of ‘interest’ income
- Existence of BC or rendering of service in India for Interest / Royalty / FTS – **Not relevant**

Money received without consideration

- Sec. 9(1)(viii), as inserted **in the Act**:

  Income **arising outside India**, being any **sum of money** referred to in sec. 2(24)(xviia), paid on or after 5 July 2019 by a Resident to a NR / Foreign Co., shall be deemed to accrue or arise in India

- Sec. 2(24)(xviia):

  'Income' includes any **sum of money** or **value of property** referred to in sec. 56(2)(x)

Money received without consideration

- Sec. 56(2)(x): Income chargeable under the head **"Income from other sources"**
  - **Money** received without consideration
  - **Immovable** property for inadequate consideration
  - **Other specified property** received for inadequate consideration

Covered by sec. 9(1)(viii)

Not covered
by sec. 9(1)(viii)

Unilateral Treaty Over-ride

International law vs. Domestic Law

- *"Subject to the provisions of this Act"* (sec. 4 and 5 of the Act)

  A tax treaty **overrides** the provisions of the Act in the matter of ascertainment of income and its chargeability to tax, to the extent of inconsistency with the terms of the treaty

International law vs. Domestic Law

› Treaty Override

When the **domestic law** of a State **overrules** provisions of one / more treaties having effect in that State (OECD report).

Can include instances of domestic interpretation of an existing provision

Int’l vs. Domestic law: Relationship

- Monistic principle
  - Treats int’l law (tax treaties) and domestic law as a part of **one overall system** (but admits the valid existence of domestic law in conflict with int’l law – Moderate Monistic).
  - International law is superior to domestic law. Eg. Netherland

Int’l vs. Domestic law: Relationship

- Dualistic approach
  - Distinguishes the two as **completely independent** systems, each having different sources
  - Requires specific domestic legislation (“*doctrine of transformation*”). Int’l law must be translated into national law, and existing national law that contradicts int’l law must be ‘***translated away***’
  - Need for translation causes problem due to national laws voted <u>**after**</u> the act of translation (*lex posterior*)

OECD Treaty Override Report (1989)

› Case 1

Outright Material breach: When a state introduces a new final WHT on payment that is exempt as per treaty

– An unsanctioned repudiation of the treaty or *"violation of a provision essential to the accomplishment of the object / purpose of the treaty."* (Art. 60 of VCLT)

– An omission / change in domestic law, affecting the object of a treaty, is a violation of Art. 60

OECD Treaty Override Report (1989)

› Case 2

New provision in domestic law, **to put an end to improper use of treaty (GAAR)**.

Possible solutions (as per OECD)

– Official protest / MAP

– Termination / Suspension / Partial suspension

– Mutual renegotiation of treaty

Instances of Treaty Over-ride: Int'l

- FATCA
  - To get treaty rates, fulfil FATCA info gathering and reporting requirements. If not, 30% WHT
- China
  - Circ. 689 in Dec. 2009 to tax sale of offshore Hold Co. having underlying Chinese interests (disregarding intermediary entity) in specific circumstances

Instances of Treaty Over-ride: India

- Anti-avoidance Override
  - Sec. 90(2A): GAAR to apply, **even if not beneficial**
- Offshore Indirect Transfer
- EQL
- Cyprus experience

Instances of Treaty Over-ride: India

- Change in a Definition
  - Software royalty
  - Process
  - POEM *(if definition provided for the purpose of the Act, is applied by the Revenue, for 'Tie-breaker' test)*

Treaty Over-ride: Validity

- Constitution
- OECD MCC
- Vienna Convention
- GAAR Committee

Treaty Over-ride

- Constitution
  - *"It is impossible to think that once a Treaty is entered into, the Parliament loses the power conferred by the Constitution, to make a law even in respect of a matter included in List I of the 7th Schedule."*

T. Rajkumar (Mad. HC)

Treaty Over-ride

› OECD MCC of Art. 1

– **Para 61:** *Treaty benefits* ***should not be available*** *where* ***a main purpose*** *for entering into certain transactions / arrangements was to* ***secure a more favourable tax position*** *and obtaining it in these circumstances would be* ***contrary to object and purpose of relevant provisions***

(Cont'd)

Treaty Over-ride

- **Para 66:** *Domestic anti-abuse rules and judicial doctrines* ***may also be used*** *to address transactions / arrangements entered into for obtaining treaty benefits in inappropriate circumstances*

- **Para 79:** *To the extent that application of a domestic* ***GAAR results in re-characterisation*** *of income /* ***redetermination*** *of taxpayer who is considered to derive such income, the provisions of the Convention will be applied* ***taking into account these changes***

Treaty Over-ride

- Vienna Convention
  - **Art. 26:** Binding, and to be performed in good faith (*Pacta sunt servanda*)
  - **Art. 27:** A party may not invoke its internal law as justification for its failure to perform a treaty
  - **Art. 31:** A treaty shall be interpreted in good faith in accordance with ordinary meaning to be given to terms of the treaty in their context and in the light of its object and purpose.

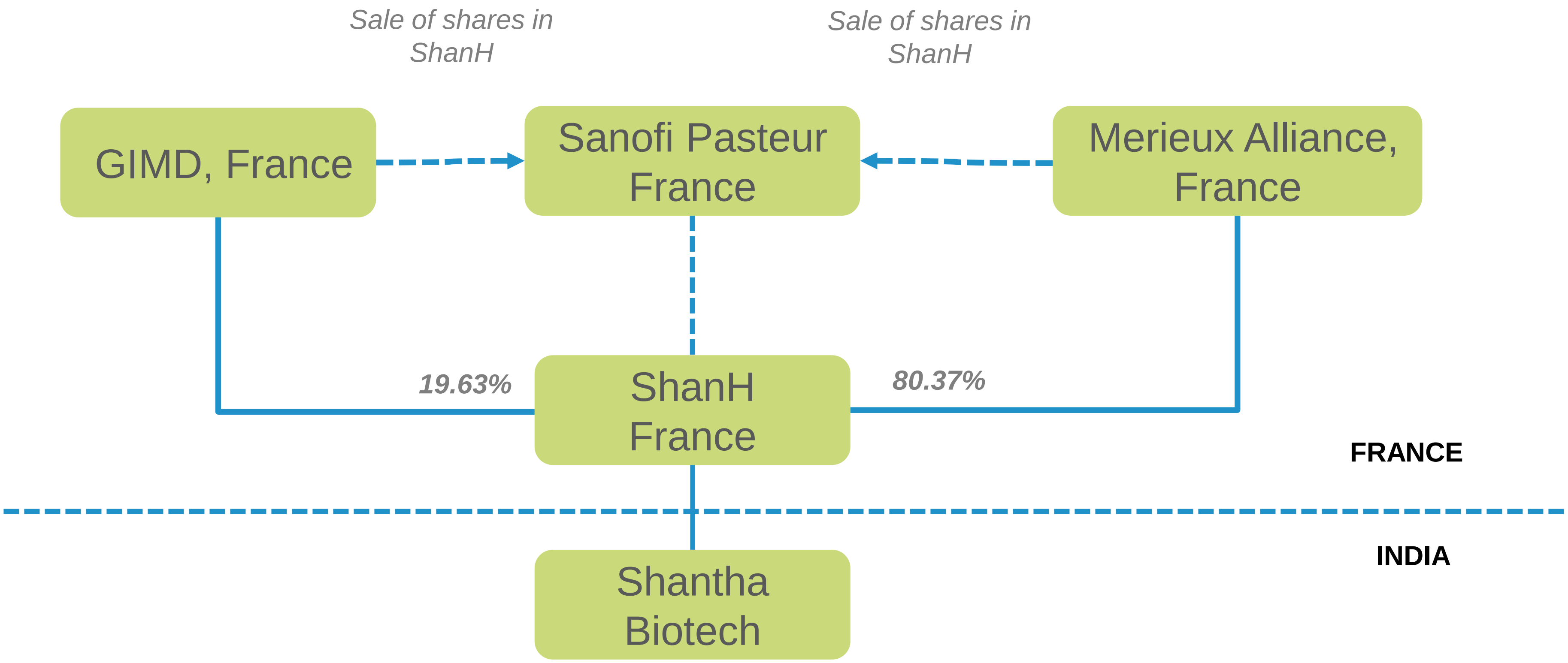
Judicial Precedents

Mauritius Treaty override

- Indostar Capital [TS-250-HC-2019 (Bom)]
  - Denied treaty benefits **on grounds of 'Tax Avoidance', without resorting to GAAR** (not challenged in SC)
  - Grandfathering denied
- AB Mauritius [TS- 635-AAR-2017]

Judicial Precedents - OIT

› Sanofi Pasteur Holding SA (AP HC)



Judicial Precedents - OIT

- Commercial Substance in ShanH
  - HC: ShanH was a French resident corporate entity with commercial substance, distinct from MA, GIMD; and not a mere nominee (as alleged)
  - Even after the transaction, commercial and business purpose of ShanH (as investment vehicle) was intact

Judicial Precedents - OIT

- Lifting of Corporate Veil of ShanH
  - ShanH was **not conceived for avoiding CGT**
  - Fact that a higher rate of CGT is payable and has been remitted to Revenue in France, lends further support to Sanofi’s contention

Judicial Precedents - OIT

- Liability to tax in India - ITA vs. DTAA
  - Controlling interest, management of SBL being identical to its shareholding (and not a separate asset), cannot be considered as distinctive value
  - **Retro-amendments do not alter DTAA provisions**
  - **Not fortified by a non-obstante clause to override DTAA provisions**
  - **Sec. 90(2): Beneficial provisions shall apply**

Change in definition

- Art. 3(2) of OECD MC

  As regards ***application of the Convention at any time*** *by a CS, any* ***term*** *not defined therein shall,* ***unless the context otherwise requires*** *or CAs agree to a different meaning (in MAP), have the meaning that it has* ***<u>at that time</u> under the income tax law of that State****, any meaning under the applicable tax laws of that State (prevailing over a meaning given under other laws of that State).*

Change in definition

- Domestic law meaning **<u>at that time</u>**:
  - When tax **is** being levied (**Ambulatory approach** 
  - When treaty **was** entered into (**Static approach**) 

Change in definition

- ‘Terms’ vs. (Ordinary) Word
  - ‘Term' is generally understood as a **word** or **phrase** **<u>used to describe a thing / to express a ‘concept’</u>**, especially in a particular language or branch of study.
- Reliance Jio Infocomm (Mum. ITAT)
  - If domestic law amendment **unsettles** the decisions favourable to RS in pre-amendment regime, ambulatory approach amounts to **unilateral override**

Amit Thapar

Qualifications: B.Com (H), CA, LL.B.

Mobile : +91 98105 56686

E-mail : amit.thapar@headsup.in

- Amit has worked for more than 14 years, with organizations such as KPMG, EY and PwC. He has an experience of 15+ yrs, specializing in Corporate and International Taxation.
- He has advised a large number of multinational corporations across sectors such as technology, oil and gas, telecom, media etc. on their tax matters.
- He has conducted trainings for client servicing teams of PwC and EY on a variety of tax topics and is frequently invited by companies to train their employees on domestic and international taxation.