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TAXMANN

<u>Course Material</u>

M.A. (INTERNATIONAL TAXATION)

1.1.3. SCOPE OF TAX TREATIES

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Scope of Tax Treaties

Module

<table>
<tr><th>Sr. No.</th><th colspan="3">Contents</th></tr>
<tr><td>1.</td><td colspan="3">Introduction</td></tr>
<tr><td>2.</td><td colspan="3">Article 3 of OECD MC and UN MC: General Definitions</td></tr>
<tr><td rowspan="4">3.</td><td colspan="3">Article 1 of OECD MC and UN MC: Persons Covered</td></tr>
<tr><td>3.1.</td><td colspan="2">Transparent Entities</td></tr>
<tr><td>3.2.</td><td colspan="2">Partnership</td></tr>
<tr><td>3.3.</td><td colspan="2">Collective Investment Vehicle</td></tr>
<tr><td rowspan="5">4.</td><td colspan="3">Article 2 of OECD MC and UN MC: Taxes Covered</td></tr>
<tr><td>4.1.</td><td colspan="2">Taxes on Income and on Capital</td></tr>
<tr><td>4.2.</td><td colspan="2">Definition of Taxes on Income and on Capital</td></tr>
<tr><td>4.3.</td><td colspan="2">List of Covered Taxes</td></tr>
<tr><td>4.4.</td><td colspan="2">New Taxes</td></tr>
<tr><td rowspan="3">5.</td><td colspan="3">Scope of Subject to Tax Clause and Liable to Tax</td></tr>
<tr><td>5.1.</td><td colspan="2">Subject to Tax Clause</td></tr>
<tr><td>5.2.</td><td colspan="2">Liable to Tax</td></tr>
<tr><td rowspan="8">6.</td><td colspan="3">Issues with Taxes Outside the Scope of Tax Treaties</td></tr>
<tr><td rowspan="4">6.1.</td><td colspan="2">Equalisation Levy</td></tr>
<tr><td>6.1.1.</td><td>Meaning of “Equalisation Levy” [Section 164(d) of the Finance Act, 2016]</td></tr>
<tr><td>6.1.2.</td><td>Charge of Equalisation Levy on ‘Specified Services’ [Section 165 of Finance Act, 2016]</td></tr>
<tr><td>6.1.3.</td><td>Charge of Equalization levy on E-commerce supply or services [Section 165A of the Finance Act, 2016]</td></tr>
<tr><td>6.2.</td><td colspan="2">Dividend Distribution Tax (DDT)</td></tr>
<tr><td>6.3.</td><td colspan="2">Surcharge</td></tr>
<tr><td>6.4.</td><td colspan="2">Cess</td></tr>
<tr><td rowspan="3">7.</td><td colspan="3">Purpose of Tax Treaty</td></tr>
<tr><td>7.1.</td><td colspan="2">Indian Tax Treaty</td></tr>
<tr><td>7.2.</td><td colspan="2">Need for Tax Treaty</td></tr>
</table>

1. Introduction

As discussed earlier, tax treaties represent an important aspect of the international tax rules of many countries. Over 3,000 bilateral income tax treaties are currently in effect, and the number is growing. The overwhelming majority of these treaties are based in large part on the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (OECD Model).

Article 2 of Vienna Convention on Law of Treaties, 1969 defines a "treaty" as an **international agreement** concluded between States in **written form** and **governed by international law**, whether embodied **in a single instrument or in two or more related instruments** and whatever its particular designation.

Tax Treaties, thus, attempt to eliminate double taxation and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned states on a rational basis. Tax treaties do not always succeed in eliminating Double Taxation, but contain the incidence to a tolerable level.

In order to enable various countries to enter into treaties, which are standardized to some extent, OECD and the UN have developed certain Model Tax Treaties.

The significant model conventions have been briefly discussed hereunder:

OECD Model - In 1961, the Organisation for Economic Co-operation and Development (OECD) was established with developed countries as its members. OECD Model Convention (OECD MC) is essentially a model treaty between two developed nations. This model advocates residence based taxation, i.e., it lays emphasis on the right of state of residence to tax the income.

Currently 34 countries including Australia, US, UK, France, Germany etc. are member of OECD. India is not a OECD member but currently has been granted the "Observer" status.

UN Model – Tax treaties between countries with unequal economic status i.e. developed and lesser developed countries, or between developing countries. Drafted in 1980, it was designed to encourage flow of investments from the developed to developing countries. The UN MC is a compromise between the source principle and the residence principle. However, it gives more weight to the source principle as against the residence principle of the OECD MC. Most of the India's tax treaties are based on UN Model.

OECD Model contains VII chapters comprising of 32 articles and UN Model also contains VII chapters but comprising of 31 articles.

2. <u>Article 3 of OECD MC and UN MC: General Definitions</u>

This Article provides the meaning of various terms used in the tax treaty. If a particular term is not defined in a tax treaty, Article 3 may provide that the meaning of such term should be construed as per the domestic tax laws.

Sr. No.	Term	Meaning/ Explanation
(a)	**Person**	The term "person" includes an individual, a company and any other body of persons. **Note**: The definition of 'person' is very significant because under Article 4, only a "person" can be a "resident" and, therefore, eligible for most benefits under the treaty. Also, it is only the "person" as defined in this paragraph of Article 3 who is eligible to claim relief under Article 25 (Mutual Agreement Procedure). The definition of person is not exhaustive and it should be read as indicating that the term "person" is used in a very wide sense.
(b)	**Company**	The term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes. **Note**: Article 3(1)(b) of the OECD/UN MC defines the term "company" to also include "any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons.
(c)	**Enterprise**	The term "enterprise" applies to the carrying on of any business.
(d)	**Enterprise of a Contracting State and enterprise of the other Contracting State**	The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State. Note: The residency of the enterprise depends on the residential status of the person carrying the enterprise and not the place from which the business is carried on.

(e)	**International Traffic**	The term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State. The definition of "international traffic" does not apply to a transport by an enterprise which has its place of effective management in one Contracting State when the ship or aircraft is operated between two places in the other State, even if part of the transport takes place outside that State. Thus, for **example**, a cruise beginning and ending in that other State without a stop in a foreign port does not constitute a transport of passengers in international traffic. Contracting States wishing to expressly clarify that point in their conventions may agree bilaterally to amend the definition accordingly.
(f)	**Competent Authority**	The definition of the term "competent authority" recognises that in some OECD member countries the execution of double taxation conventions does not exclusively fall within the competence of the highest tax authorities; some matters are reserved or may be delegated to other authorities. The present definition enables each Contracting State to designate one or more authorities as being competent. **Note:** The competent authorities are those bodies of each Contracting State vested with the authority to determine issues relating to the convention in particular under the Mutual Agreement Procedures (Article 25) and the Exchange of Information (Article 26). The definition has regard to the fact that under certain treaties, execution does not exclusively fall within the jurisdiction of the highest tax authorities. Where the jurisdiction on some matters are reserved for or delegated to other authorities, this definition enables each country to designate one or more authorities as being competent to determine issues relating to the convention. In India, the competent authority is the **Ministry of Finance (Department of Revenue) of the Central Government** or their authorised representative.

(g)	**National**	As per **OECD Model Convention**, the term "national", in relation to a Contracting State, means: (i) any individual possessing the nationality or citizenship of that Contracting State; and (ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State. As per **UN Model Convention**, the term "national" means: (i) any individual possessing the nationality of a Contracting State; (ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State. **Note:** The definition of "national" is primarily relevant to Article 24 dealing with non-discrimination. The usage of the word "citizenship" has been particularly excluded in Article 3(1)(f) of the UN MC. The meaning of the term "national" depends on the sense in which the term is used and also on the rules pertaining to acquisition or loss of nationality adopted by each Contracting State. With respect to legal persons, partnerships or association, their nationality depends on the laws in force in that respective Contracting State. Further, the distinct mention of partnership is necessary to avoid confusion as some domestic laws may categorise an entity as a 'person' but not a 'legal person' for tax purposes.
(h)	**Business**	The term "business" includes the performance of professional services and of other activities of an independent character. **Note:** The UN Model Convention does not contain a definition of the term "enterprise" and "business". In common parlance, enterprise means an economic activity carried on by a person capable of producing profits. It would be important to note that, as per the OECD MC, the performance of professional services or other activities of an independent character would constitute an "enterprise"

		irrespective of the meaning of that term as per the domestic laws. This is due to the reason that enterprise is defined as carrying on of any business and the term “business” has been explicitly defined in Article 3(1)(h) of the OECD MC to include the “performance of professional services and of other activities of an independent character”. This definition was included to enable income from professional services or other activities of an independent character to be taxed under Article 7 of the OECD MC and not under Article 21 (Other Income).
(i)	**Recognised Pension Fund**	The term “recognised pension fund” of a State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and: (i) that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or (ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in sub division (i).

As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Note: Article 3(2) essentially contains a general rule concerning the meaning of terms used but not defined in the tax treaty. The general rule as embodied in the MC is that if any undefined term is used in the tax treaty, its meaning can be adopted from the meaning assigned to such a word under the domestic law of the Contracting State **at the time when the tax is being levied**.

If, however, such a term is defined in both the tax and non-tax laws of a Contracting State, the definition provided in the tax law has to be considered. Moreover, where multiple definitions are provided, the definition used for purpose of the particular provision at issue, if any, should be used.

3. <u>Article 1 of OECD MC and UN MC: Persons Covered</u>

This Convention shall apply to persons who are residents of one or both of the Contracting States.

For the purposes of the Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State. However, the same would be treated as income only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

Note: Article 1(2) of OECD and UN MCs are identical. It addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes, such as trusts and partnership firms.

Example: State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company, and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership, and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28 of OECD Model Convention and paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 A 23 [B], 24, 25A 25B and 28 of UN Model Convention.

Note: Article 1(3) of UN and OECD MC provides that, with the exception of benefits granted under certain Articles of these conventions, these Conventions would not affect the taxation, by a Contracting State, of its resident. The intent of the saving clause is to put at rest the argument that some provisions aimed at the taxation of non-residents could be interpreted as limiting a Contracting State's right to tax its own residents.

3.1. Transparent Entities

The concept of "**fiscally transparent**" used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement.

For the purposes of these Conventions, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State. However, the same would be treated as income only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

3.2. Partnership

Domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax Conventions in relation to partnerships.

A main source of difficulties is the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries adopt what may be referred to as the fiscally transparent approach, under which the partnership is ignored for tax purposes and the individual partners are taxed on their respective share of the partnership's income.

"Liable to tax" is a precondition to consider a person as resident of a Contracting State, however, where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State.

In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity.

For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

Consequently, Article 1(2) clarifies that the Convention will apply to the partnership's income to the extent that the income is treated, for purposes of taxation by that State, as the income of a partner who is a resident of that State. The same treatment will apply to income of other entities or arrangements that are treated as fiscally transparent under the tax law of a Contracting State.

3.3. Collective Investment Vehicle

Most countries have dealt with the domestic tax issues arising from groups of small investors who pool their funds in collective investment vehicles (CIVs). In general, the goal of such systems is to provide for neutrality between direct investments and investments through a CIV. whilst those systems generally succeed when the investors, the CIV and the investment are all located in the same country, complications frequently arise when one or more of those parties or the investments are located in different countries.

The primary question that arises in the cross-border context is whether a CIV should qualify for the benefits of the Convention in its own right. Whether a CIV would have to qualify as a “person” that is a “resident” of a Contracting State and, as regards the application of Articles 10 and 11, that is the “beneficial owner” of the income that it receives.

The determination of whether a CIV should be treated as a “person” begins with the legal form of the CIV, which differs substantially from country to country and between the various types of vehicles. In many countries, most CIVs take the form of a company. In others, the CIV typically would be a trust. In still others, many CIVs are simple contractual arrangements or a form of joint ownership. In most cases, the CIV would be treated as a taxpayer or a “person” for purposes of the tax law of the State in which it is established; for example, in some countries where the CIV is commonly established in the form of a trust, either the trust itself, or the trustees acting collectively in their capacity as such, is treated as a taxpayer or a person for domestic tax law purposes. In view of the wide meaning to be given to the term “person”, the fact that the tax law of the country where such a CIV is established would treat it as a taxpayer would be indicative that the CIV is a “person” for treaty purposes. Contracting States wishing to expressly clarify that, in these circumstances, such CIVs are persons for the purposes of their conventions may agree bilaterally to modify the definition of “person” to include them.

Whether a CIV is a “resident” of a Contracting State depends not on its legal form (as long as it qualifies as a person) but on its tax treatment in the State in which it is established. Although a consistent goal of domestic CIV regimes is to ensure that there is only one level of tax, at either the CIV or the investor level, there are a number of different ways in which States achieve that goal. In some States, the holders of interests in the CIV are liable to tax on the income received by the CIV, rather than the CIV itself being liable to tax on such income. Such a fiscally transparent CIV would not be treated as a resident of the Contracting State in which it is established because it is not liable to tax therein.

Some countries have questioned whether a CIV, even if it is a “person” and a “resident”, can qualify as the beneficial owner of the income it receives. Because a “CIV” as defined above must be widely-held, hold a diversified portfolio of securities and be subject to investor-protection regulation in the country in which it is established, such a CIV, or its managers, often perform significant functions with respect to the investment and management of the assets of the CIV. Moreover, the position of an investor in a CIV differs substantially, as a legal and economic matter, from the position of an investor who owns the underlying assets, so that it would not be appropriate to treat the investor in such a CIV as the beneficial owner of the income received by the CIV. Accordingly, a vehicle that meets the definition of a widely-held CIV will also be treated as the beneficial owner of the dividends and interest that it receives, so long as the managers of the CIV have discretionary powers to manage the assets generating such income (unless an individual who is a resident of that State who would have received the income in the same circumstances would not have been considered to be the beneficial owner thereof).

In order to provide more certainty under existing treaties, tax authorities may want to reach a mutual agreement clarifying the treatment of some types of CIVs in their respective States.

4. <u>Article 2 of OECD MC and UN MC: Taxes Covered</u>

This Article provides the details of taxes, which would be covered for the purpose of tax treaty. Any tax which is not provided in Article 2 is outside the purview of the tax treaty.

4.1. Taxes on Income and on Capital

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.

Paragraph 1 provides the scope of application of the tax treaty. The tax treaty shall apply to taxes on income and on capital. It further elaborates that the taxes can be imposed by the Contracting States including its political sub-divisions and local authorities and it is immaterial if the taxes are levied through direct assessment or through deduction of tax at source, in the form of surtaxes or surcharges or as additional taxes. The tax treaty only intends to clarify the categories of taxes to which it would apply.

4.2. Definition of Taxes on Income and on Capital

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.

This paragraph gives a definition of taxes on income and on capital. Such taxes comprise taxes on total income and on elements of income, on total capital and on elements of capital. They also include taxes on profits and gains derived from the alienation of movable or immovable property, as well as taxes on capital appreciation. Finally, the definition extends to taxes on the total amounts of wages or salaries paid by undertakings. Social security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as “taxes on the total amount of wages”.

Clearly a State possessing taxing powers — and it alone — may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty. Practice among member countries varies with respect to the treatment of interest and penalties. Some countries never treat such items as taxes covered by the Article. Others take the opposite approach, especially in cases where the additional charge is computed with reference to the amount of the underlying tax. Countries are free to clarify this point in their bilateral negotiations.

The Article does not mention "ordinary taxes" or "extraordinary taxes". Normally, it might be considered justifiable to include extraordinary taxes in a model convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.

4.3. List of Covered Taxes

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

a) (in State A): ……………………..
b) (in State B): ……………………..

This paragraph lists the taxes in force at the time of signature of the Convention. The list is not exhaustive. It serves to illustrate the preceding paragraphs of the Article. In principle, however, it will be a complete list of taxes imposed in each State at the time of signature and covered by the Convention.

Some member countries do not include paragraphs 1 and 2 in their bilateral conventions. These countries prefer simply to list exhaustively the taxes in each country to which the Convention will apply, and clarify that the Convention will also apply to subsequent taxes that are similar to those listed. Countries that wish to follow this approach might use the following wording:

1. The taxes to which the Convention shall apply are:
    a) (in State A): ....
    b) (in State B): ....

2. 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 taxes listed in paragraph 1. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

As mentioned in above paragraph, social security charges and similar charges should be excluded from the list of taxes covered.

4.4. New Taxes

The Convention shall also apply 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(4) is phrased to accommodate any subsequent changes in the taxation laws of the Contracting States. The tax treaty, in effect, would apply to all the taxes that are identical or substantially similar to the taxes in force at the time of entering into the tax treaty and this Paragraph is essentially included to avoid the necessity to conclude a new treaty every time the tax laws of the Contracting States are amended. In order to facilitate the same, each Contracting State is to notify the other of any significant changes made to its taxation laws by communicating to it, for example, details of new or substituted taxes. Member countries are encouraged to communicate other significant developments as well, such as new regulations or judicial decisions; many countries already follow this practice.

5. <u>Scope of Subject to Tax Clause and Liable to Tax</u>

5.1. Subject to Tax Clause

The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business with that country or in that country. Internationally, the term used to determine the jurisdiction for taxation is "connecting factors". There are two types of connecting factors, namely, "Residence" and "Source". It means a company can be subject to tax either on its residence link or its source link with a country.

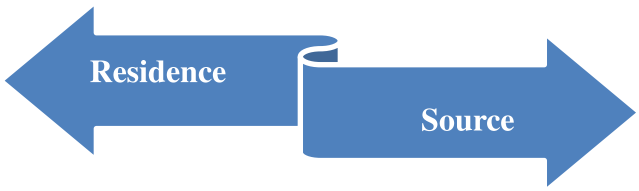

Fig: Two Types of Connecting Factors

If a company is doing business in a host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link as the company would be heavily engaged in doing business in the territory of other country, for example, through its branch in that country.

However, if a company is doing business with another country (i.e., host/source country), then, it would generally be subject to tax in its home country alone, based on its residence link, since the company is not engaged in carrying on the business in the territory of source country (for example, export of goods to another country). In this regard, it may, however, be noted that significant economic presence in another country may result in tax liability in the other country.

For **example**, as per the Income-tax Act, 1961, transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India if aggregate of payments arising from such transaction or transactions during the previous year exceeds ` 2 crores, would be deemed as significant economic presence of such non-resident in India. Significant economic presence of a non-resident in India would constitute business connection in India and consequently, income would be deemed to accrue or arise in India and hence, be taxable in India (the Source country).

5.2. Liable to Tax

As per Article 4 of OECD MC and UN MC, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

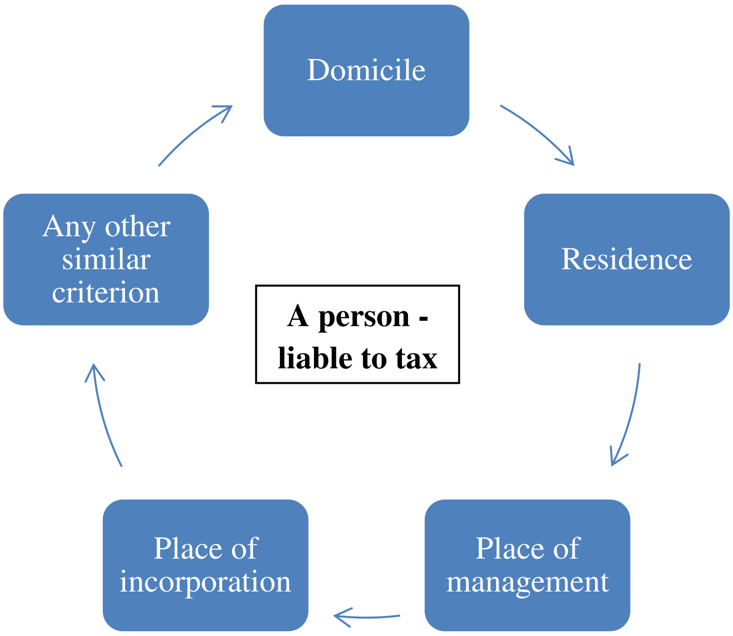

Fig: Person Liable to Tax

As per this paragraph, a person is a resident of a Contracting State if he is liable to tax under the laws of that Contracting State as per the criterion mentioned therein, i.e., domicile, residence, place of management etc. The convention in this regard, intends to cover only the persons subject to comprehensive tax on their total income and thereby specifically excludes any person, who is paying tax only on income from sources in the State.

Meaning of "liable to tax": A resident is a person who is 'liable to tax'. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organisations are subject to tax law but may be exempt under domestic laws upon satisfying some conditions. Most States view such entities as 'liable to tax'. However, some States do not consider entities as being resident if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention.

6. <u>Issues with Taxes Outside the Scope of Tax Treaties</u>

6.1. Equalisation Levy

Consequent to the Base Erosion and Profit Shifting (BEPS) Action Report 1, a committee was constituted by the CBDT to evaluate the alternatives suggested in the BEPS Action Report 1 for addressing the challenges arising on taxing the digital economy. Pursuant to the recommendations of the Committee, Chapter VIII of the Finance Act, 2016, titled "Equalisation Levy" was introduced. It provides for an equalisation levy @ 6% of the amount of consideration for specified services received or receivable by a non-resident not having PE in India, from a resident in India who carries out business or profession, or from a non-resident having PE in India.

One of the primary reasons for introducing the Equalisation Levy through the Finance Act is to deny tax treaty benefits, as otherwise it may defeat the entire purpose of introducing the Equalisation Levy. The CBDT constituted Committee specifically addresses this aspect in their report and clarifies that tax credit under the relevant tax treaties would not be available, since Equalisation Levy is not in the nature of income tax.

The CBDT issued a notification dated 27th May, 2016, stating that the provisions of Chapter VIII relating to the equalisation levy would come into effect from 1st June 2016. This Chapter extends to the whole of India except Jammu and Kashmir. It applies in respect of consideration received or receivable for specified services provided on or after 1.6.2016.

In order to widen and deepen the equalisation levy net beyond online advertisement, its scope had been extended by the Finance Act, 2020 to consideration received or receivable for e-commerce supply or services made or provided or facilitated on or after 1.4.2020.

However, the consideration received or receivable for specified services and for ecommerce supply or services would not include the consideration, which are taxable as royalty or fees for technical services in India under the Income-tax Act, read with the DTAA notified by the Central Government under section 90 or section 90A.

The statutory provisions relating to the levy and collection of the equalisation levy do not form part of the IT Act. It has been introduced as a separate levy under the Finance Act, 2016. The equalisation levy has been brought into force to tackle direct tax issues relating to digital businesses. This is also supported by the concept of 'horizontal equity'; that is, taxing digital services rendered by non-residents with the objective of equalising their tax burden with other Indian competitors who are subject to income tax in India. Further, the equalisation levy is chargeable where the non-resident does not have a fixed permanent establishment in India. If there is a permanent establishment in India, then the profits attributable will be subject to income tax in India. The difference in these two situations clearly suggests that what is not covered by the IT Act is now covered through the equalisation levy. Moreover, the income of a non-resident who has suffered the equalisation levy is exempt from income tax under the IT Act. Thus, the object and purpose of the levy suggests that it is an alternate form of income tax, though not introduced under the IT Act or per se as 'income tax'.

On the one hand, the profits earned by a non-resident are subject to income tax in their home state and on the other, the gross receipts of non-residents are taxable in India (host state) in the form of the 'equalisation levy'. This is leading to double taxation. This concern has also been recognised in the final report of Base Erosion and Profit Shifting (BEPS) Action Plan – 1.

The objective of the equalisation levy was to tax non-residents who remained untaxed, mainly due to a lack of adequate provisions, either under the DTAAs or IT Act. But the imposition of a unilateral levy through the domestic tax laws of India appears to contradict bilateral treaty obligations. It is ironic that taxpayers who remained untapped for tax payments in the source country will now have to pay tax in two states without any immediate solution against such juridical double taxation. Also, while framing the law, the Indian Government has kept in view its own interest and completely ignored the taxpayer's perspective.

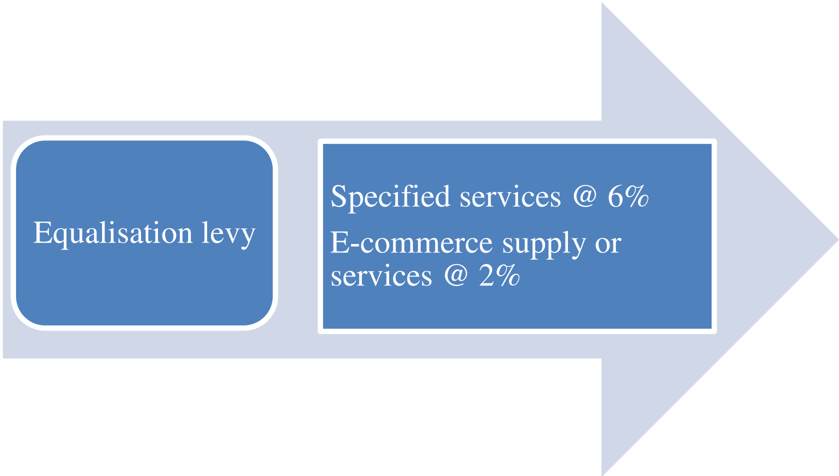

Fig: Equalisation Levy

The key aspects related to Equalisation Levy have been discussed below.

6.1.1. Meaning of "Equalisation Levy" [Section 164(d) of the Finance Act, 2016]

Equalisation levy means the tax leviable on consideration received or receivable for any specified service or e-commerce supply or services.

Meaning of '**specified service**':

(i) Online advertisement,
(ii) any provision for digital advertising space, or any other facility or service for the purpose of online advertisement,
(iii) Any other service as may be notified by the Central Government.

Note: 'Online' means a facility or service or right or benefit or access that is obtained through the internet or any other form of digital or telecommunication network.

Meaning of '**E-Commerce Supply or Services**':

(i) online sale of goods owned by the e-commerce operator; or
(ii) online provision of services provided by the e-commerce operator; or
(iii) online sale of goods or provision of services or both, facilitated by the e-commerce operator; or
(iv) any combination of activities listed in (i), (ii) or (iii) above.

"Online sale of goods" and "online provision of services" would include one or more of the following online activities:

a) acceptance of offer for sale; or
b) placing of purchase order; or
c) acceptance of the purchase order; or
d) payment of consideration; or
e) supply of goods or provision of services, partly or wholly.

6.1.2. Charge of Equalisation Levy on 'Specified Services' [Section 165 of Finance Act, 2016]

Equalisation levy @ 6% is leviable on the amount of consideration for specified service received or receivable by a person, being a non-resident from –

a) a person resident in India and carrying on business or profession; or
b) a non-resident having a PE in India.

Equalisation levy is not chargeable, where –

a) the non-resident providing the specified service has a PE in India and the specified service is effectively connected with such PE;
b) the aggregate amount of consideration for specified service received or receivable in a previous year by the non-resident from a person resident in India and carrying on business or profession, or from a non-resident having a PE in India, does not exceed ` 1 lakh; or
c) where the payment for the specified service by the person resident in India, or the PE in India is not for the purposes of carrying out business or profession.

6.1.3. Charge of Equalization levy on E-commerce Supply or Services [Section 165A of the Finance Act, 2016]

Equalization levy @ 2% would be chargeable on the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it—

1) to a person resident in India; or
2) to a non-resident in the specified circumstances as provided below; or
3) to a person who buys such goods or services or both using internet protocol address located in India.

The equalization levy shall not be charged—

1) where the e-commerce operator making or providing or facilitating e-commerce supply or services **has a permanent establishment in India** and such ecommerce supply or services is effectively connected with such PE;
2) where the equalization levy **is leviable under section 165**; or
3) **sales, turnover or gross receipts**, as the case may be, of the e-commerce operator from the e-commerce supply or services made or provided or facilitated **is less than ` 2 crore** during the previous year.

6.2. Dividend Distribution Tax (DDT)

Prior to 1997, dividends were taxable in the hands of the shareholder. In 1997, for administrative convenience, the Indian tax laws were amended to provide for a levy of DDT at the rate of 15% (plus applicable surcharge and cess) on the company distributing the dividends. This meant that the brunt of the tax was shifted to the companies declaring dividends and that dividend were exempt from such taxation in the hands of the shareholders.

The DDT was discharged by Indian companies at the said rate irrespective of whether the shareholders were residents or non-residents. The shareholders who were tax residents of countries with which India had entered into a tax treaty were not given the benefit of the tax rate prescribed under the relevant tax treaty at the time of levying the DDT on the dividends distributed by Indian companies. While most of the tax treaties entered into by India provide for a lower tax rate for a beneficial owner of dividend income (as compared to the DDT), it was generally believed and accepted that a tax treaty would not override the DDT provisions.

In Finance Bill, 2020, the government abolished the DDT charged u/s 115-O of the Income Tax Act, 1961. However government has inserted/ amended certain sections to make the Dividend income taxable in the hands of receiver by removing Section 10(34) of the Act.

Tax on Distributed Profits of Domestic Companies** [Section 115-**O]

From 1.4.2020, dividend distributed by domestic company will no longer be subject to DDT if dividend is distributed on or after 1st April 2020.

Exemption of Dividend referred u/s 115-O [Section 10(34)]

From 1.4.2020, dividend distributed by domestic company will no longer be exempt in the hands of recipient.

Any income by way of dividend received from a company, whether domestic or foreign, is taxable in the hands of shareholder at normal rates of tax.

However, dividend distributed by a domestic company before 1.4.2020 and received by the shareholders on or after 1.4.2020 and on which dividend distribution tax under section 115-O, if applicable, has been paid would be exempt in the hands of the shareholders except dividend chargeable to tax u/s 115BBDA.

Tax on Certain Dividends Distributed by Domestic Companies before 1.4.2020 but received on or after 1.4.2020 [Section 115BBDA]

Any income by way of aggregate dividend **in excess of ` 10 lakh** distributed by domestic companies before 1.4.2020 but received on or after 1.4.2020 shall be chargeable to tax in the case of specified assessee who is **resident in India**, at the rate of **10%** [further, increased by surcharge, if applicable and health and education cess @ 4%].

Meaning of Certain Terms

Term	Meaning
Specified Assessee	A person, resident in India, other than • domestic company • a fund or institution or trust or any university or other educational institution or any hospital or other medical institution referred to in section 10(23C)(iv)/(v)/(vi)/(via) • a trust or institution registered under section 12A or 12AA
Dividend	Includes dividend referred under section 2(22)(a) to (d) but shall not include sub-clause (e) thereof.

Further, the taxation of dividend income in excess ` 10 lakh shall be on gross basis i.e., no deduction in respect of any expenditure or allowance or set-off of loss shall be allowed to the assessee in computing the income by way of dividends.

6.3. Surcharge

A surcharge is discussed under Article 270 and 271 of the Constitution. A surcharge is stated to be “an increase” in any of the duties and taxes referred to in Articles 269 and 270. In simple words, a surcharge is a tax on tax.

Surcharges have primarily been imposed on the highest income tax slab on the basis that relatively well-off taxpayers need to shoulder a greater share of the tax burden. However, the same objective can be achieved by rationalising the income tax rates instead of imposing a surcharge in addition to income tax. Surcharges should not be used as a proxy for a progressive income tax.

6.4. Cess

The amount collected under a cess varies across statutes and could be either fixed or ad valorem. It is typically imposed as an addition to an existing tax.

The Union Government should not levy cesses for purposes that are contained in the State List. The health and education cess is a prominent example of one such cess.

In case of exceptional circumstances such as natural calamities, the Disaster Management Act, 2005 envisages permanent National and State level Disaster Response Fund and Disaster Mitigation Fund. Efforts must be made by Central and State Government to ensure adequate revenue in such funds. If despite such funds, additional revenue is required, a specific purpose cess in extraordinary circumstances may be legislated subject to a maximum percentage increase of 1% over the benchmarked ceiling. If necessary, other cesses may be abolished to adhere to this ceiling.

The similarities between a cess and a surcharge are that both levies are exceptions under Article 270. The revenues collected from both these sources are at the exclusive disposal of the Union Government. However, a cess is levied for a pre-determined earmarked purpose while a surcharge can be appropriated for any public purpose. This distinction between a cess and a surcharge drawn by the Constitution, means that the two terms are not interchangeable.

Under the Income Tax Act, any special rate of tax (on capital gains, royalty income under Section 115A etc), the tax computed is to be increased by applying surcharge and education cess etc. The definition of tax in the treaties is however, ‘all in one type’. Therefore, no additional surcharge and education cess is to be applied over the treaty rate.

In other words, for special rates specified in the treaty, presumably, the surcharge and education cess etc. are already included in the rate. However, for other types of income like business income etc. which are assessed according to the domestic tax law, the tax once computed applying the rate table, will have to be increased by surcharge and education cess.

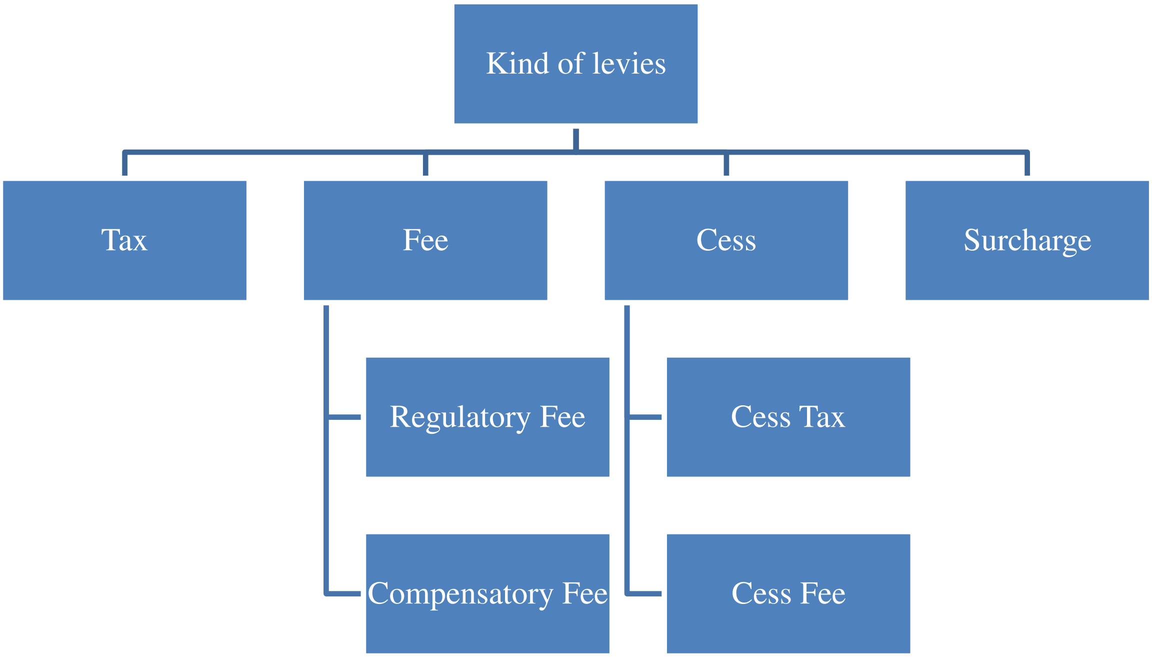

Fig: Kind of Levies

7. <u>Purpose of Tax Treaties</u>

The purposes for signing a tax treaty also play a significant role in its interpretation as they determine the context in which a particular treaty is signed. Such purposes for signing the treaty are reflected in the preamble of the treaty.

The principal purposes of tax treaties are as follows:

- To protect tax payers against double taxation (whether direct or indirect)
- To eliminate double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)
- To encourage free flow of international trade and investment
- To encourage transfer of technology
- To prevent discrimination between tax payers
- To provide a reasonable element of legal and fiscal certainty to investors and traders
- To arrive at an acceptable basis to share tax revenues between two States
- To improve the co-operation between taxing authorities in carrying out their duties

7.1. Indian Tax Treaties

Section 90 of the Income-tax Act, 1961 contains the purposes of signing tax treaties in general. The same are as follows:

(a) for granting of relief in respect of –
   - (i) income on which taxes have been paid, both income-tax under this Act and income-tax in that country; or
   - (ii) income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade and investment, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements), or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country.

Thus, it can be observed that there are several purposes for entering into tax treaties by the Government of India besides the primary purpose of avoidance of double taxation as enumerated above.

7.2. Need for Tax Treaties

The concept of source and residence prevailing in a majority of the countries is the root cause of double taxation. Hence, there is a need to have tax treaties in force.

There are various important considerations for the need of tax treaty as mentioned below:

- Allocating the taxing rights
- Eliminating double taxation
- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.

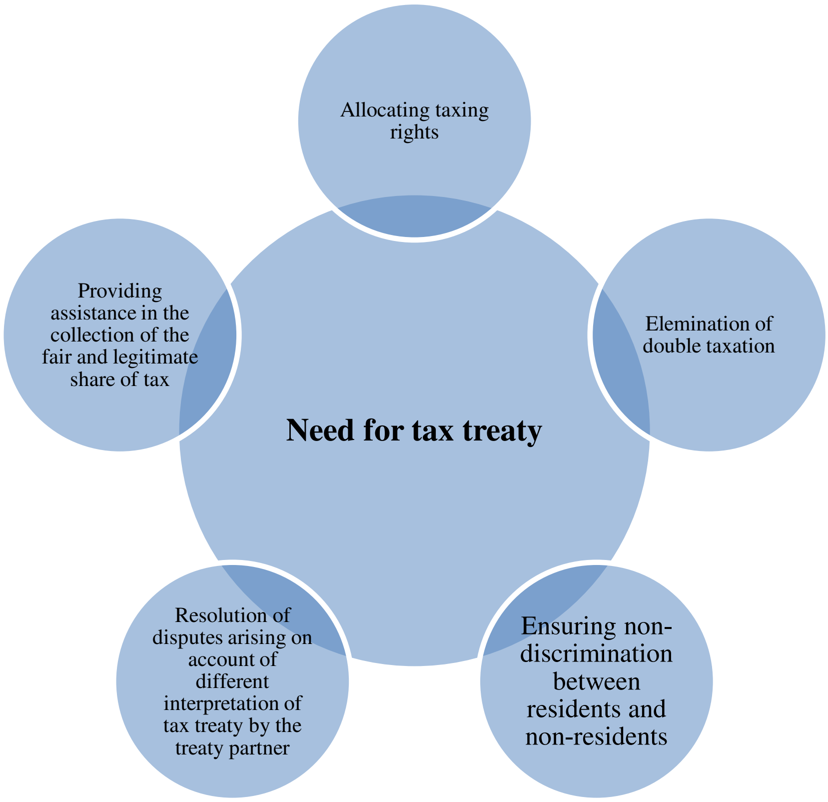

Fig: Need for the Tax Treaty

Test Your Knowledge

QUESTIONS	
1.	"In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into tax treaty". Elucidate.
2.	Examine and state the correctness or otherwise of the following statement in the context of international tax treaties between the countries and answer in brief with reason/content thereof: "Providing assistance in the collection of the fair and legitimate share of tax by the countries involved is the sole objective of tax treaties entered into between countries."
3.	Himachal Ltd. is an Indian Company involved in manufacturing and trading in woollen garments under the brand name "HWOOL". In order to expand its exports sale, it launched a massive publicity campaign in overseas market. For the purpose of online advertising, it hired Doodle Inc., a Country D based company, which has no permanent establishment in India, and paid ` 20 lakhs for its services in the previous year 2021-22. Discuss the tax and TDS implications of such transaction both in the hands of Himachal Ltd. and Doodle Inc.
4.	ABC Inc., a Country A based company, has a liaison office at Delhi (opened with the permission of RBI), where the orders are booked for supply of mobile phones directly to customers in India. The salary and administrative expenses of liaison office are met directly by ABC Inc. During the financial year 2021-22, the liaison office procured for ABC Inc., orders for 1,00,000 mobile phones from various customers in India. In addition, ABC Inc. procured orders for 50,000 mobile phones directly from customers in India. ABC Inc. made profits from orders procured directly as well as through the liaison office. Does the liaison office in Delhi constitute a PE of ABC Inc. in India? If so, will ABC Inc. be liable to tax in India only in respect of profit earned by it from orders procured through its liaison office in Delhi? Examine in the context of India-Country A DTAA which is in line with the UN Model Convention, 2017.

SOLUTIONS	
1.	In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into a tax treaty, as mentioned below: • Ensuring non-discrimination between residents and non-residents • Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner. • Providing assistance in the collection of the fair and legitimate share of tax.
2.	The statement is <u>not correct</u>. The purpose of tax treaties also include: (a) allocating tax rights, (b) elimination of double taxation, (c) ensuring non-discrimination between residents and non-residents and (d) resolution of disputes of on account of different treaty interpretation.
3.	Equalisation levy of 6% is attracted in respect of the amount of consideration exceeding ` 1 lakh for, inter alia, online advertisement, received or receivable by a non-resident not having permanent establishment in India, from, inter alia, a resident in India who carries on business or profession. In this case, the payment of ` 20 lakhs by Himachal Ltd., a resident in India (since it is an Indian company) to Doodle Inc., Country D, a non-resident not having PE in India, for online advertisement services would be subject to equalisation levy @ 6%. Such income is, however, exempt under the Income-tax Act, 1961 by virtue of section 10(50) thereof. Himachal Ltd. is required to deduct equalisation levy of ` 1,20,000 i.e., @ 6% of ` 20 lakhs from such payment.
4.	The term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. However, the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character would not constitute a permanent establishment. In the present case, the liaison office of ABC Inc. would constitute a PE, since its activities are not of preparatory or auxiliary character but for procuring orders for supply of mobile phones directly to customers in India.

	In the case of *Jebon Corporation India*, the Karnataka High Court held that securing and processing orders have led to the liaison office forming a PE in India. Consequently, the profits attributable to the PE would be chargeable to tax in India. The Force of Attraction Rule implies that when a foreign enterprise sets up a PE in the State of Source, it brings itself within the fiscal jurisdiction of that State (State of Source) to such a degree that all profits that the enterprise derives from State of Source, whether through the PE or not, can be taxed by it (State of Source). In the present case, since ABC Inc. is a Country A based company, the taxability of profits attributable to the PE would be determined based on India-Country A DTAA, which is in line with the UN Model Convention, 2017. The UN Model Convention, 2017 incorporates the Force of Attraction Rule. Since the India-Country A DTAA contains the Force of Attraction Rule, the same will apply in the present case. Accordingly, the profits earned by ABC Inc. from orders for mobile phones procured in India, whether through the liaison office or not, would be subject to tax in India.