Centre for Tax Laws (CTL)

Directorate of Distance Education

NALSAR University of Law, Hyderabad

In collaboration with

TAXMANN

Course Material

M.A. (INTERNATIONAL TAXATION)

2.3.12. TAX AVOIDANCE

Prepared by
TAXMANN

(For private circulation only)

NALSAR University of Law, Hyderabad (Print 2022)

(For private circulation only)

Tax Avoidance

Module I – General

1. Introduction

Tax avoidance is the legal usage of the tax regime in a single territory to one's own advantage to reduce the amount of tax that is payable by means that are within the law. A tax shelter is one type of tax avoidance, and tax havens are jurisdictions that facilitate reduced taxes. Tax avoidance should not be confused with tax evasion, which is illegal.

Forms of tax avoidance that use legal tax laws in ways not necessarily intended by the government are often criticized in the court of public opinion and by journalists. Many corporations and businesses that take part in the practice experience a backlash from their active customers or online. Conversely, benefiting from tax laws in ways that were intended by governments is sometimes referred to as tax planning. The World Bank's World Development Report 2019 on the future of work supports increased government efforts to curb tax avoidance as part of a new social contract focused on human capital investments and expanded social protection.

"Tax mitigation", "tax aggressive", "aggressive tax avoidance" or "tax neutral" schemes generally refer to multi-territory schemes that fall into the grey area between common and well-accepted tax avoidance, such as purchasing municipal bonds in the United States, and tax evasion but are widely viewed as unethical, especially if they are involved in profit-shifting from high-tax to low-tax territories and territories recognised as tax havens. Since 1995, trillions of dollars have been transferred from OECD and developing countries into tax havens using these schemes.

Laws known as General Anti-Avoidance Rule (GAAR) statutes, which prohibit "aggressive" tax avoidance, have been passed in several countries and regions including Canada, Australia, New Zealand, South Africa, Norway, Hong Kong and the United Kingdom. In addition, judicial doctrines have accomplished the similar purpose, notably in the United States through the "business purpose" and "economic substance" doctrines established in Gregory v. Helvering and in the United Kingdom in Ramsay. The specifics may vary according to jurisdiction, but such rules invalidate tax avoidance that is technically legal but is not for a business purpose or is in violation of the spirit of the tax code.

The term "avoidance" has also been used in the tax regulations of some jurisdictions to distinguish tax avoidance foreseen by the legislators from tax avoidance exploiting loopholes in the law such as like-kind exchanges. The US Supreme Court has stated, "The legal right of an individual to decrease the amount of what would otherwise be his taxes or altogether avoid them, by means which the law permits, cannot be doubted".

Generally, taxpayers would like to reduce their tax burden through permissible and non-permissible tax reduction methods. Here, a large number of tax reduction measures (including the illegal tax evasion) are followed by income taxpayers – both corporate and personal income taxpayers. The different methods adopted to reduce tax liability can be broadly classified into four: tax evasion, tax avoidance, tax mitigation and tax planning. The difference between the four is quite narrow, depending upon interpretations in each tax regimes. Some tax reduction measures like tax mitigation, tax planning and tax avoidance are legally permissible. On the other hand, tax evasion is illegal.

2. Tax Evasion

In 1968, Nobel laureate economist Gary Becker first theorized the economics of crime, on the basis of which authors M.G. Allingham and A. Sandmo produced, in 1972, an economic model of tax evasion. This model deals with the evasion of income tax, the main source of tax revenue in developed countries. According to the authors, the level of evasion of income tax depends on the detection probability and the level of punishment provided by law. Later studies however, pointed limitations of the model, highlighting that individuals are also more likely to comply with taxes when they believe that tax money is appropriately used and when they can take part on public decisions.

The literature's theoretical models are elegant in their effort to identify the variables likely to affect non-compliance. Alternative specifications, however, yield conflicting results concerning both the signs and magnitudes of variables believed to affect tax evasion. Empirical work is required to resolve the theoretical ambiguities. Income tax evasion appears to be positively influenced by the tax rate, the unemployment rate, the level of income and dissatisfaction with government. The U.S. Tax Reform Act of 1986 appears to have reduced tax evasion in the United States.

In 2017, a study concluded based on random stratified audits and leaked data that occurrence of tax evasion rises sharply as amount of wealth rises and that the very richest are about 10 times more likely than average people to engage in tax evasion.

Tax evasion is an illegal attempt to defeat the imposition of taxes by individuals, corporations, trusts, and others. Tax evasion often entails the deliberate misrepresentation of the taxpayer's affairs to the tax authorities to reduce the taxpayer's tax liability, and it includes dishonest tax reporting, declaring less income, profits or gains than the amounts actually earned, overstating deductions, using bribes against authorities in countries with high corruption rates and hiding money in secret locations.

Tax evasion is an activity commonly associated with the informal economy. One measure of the extent of tax evasion (the "tax gap") is the amount of unreported income, which is the difference between the amount of income that should be reported to the tax authorities and the actual amount reported.

In contrast, tax avoidance is the legal use of tax laws to reduce one's tax burden. Both tax evasion and tax avoidance can be viewed as forms of tax noncompliance, as they describe a range of activities that intend to subvert a state's tax system, but such classification of tax avoidance is disputable since avoidance is lawful in self-creating systems. Both tax evasion and tax avoidance can be practiced by corporations, trusts, or individuals.

2.1. Concept of Tax Gap

The tax gap describes how much tax should have been raised in relation to much tax is actually raised. The tax gap is mainly growing due to two factors, the lack of enforcement on the one hand and the lack of compliance on the other hand. The former is mainly rooted in the costly enforcement of the taxation law. The latter is based on the foundation that tax compliance is costly for individuals as well as firms (tax filling, bureaucracy), hence not paying taxes would be more economical in their opinion.

2.2. Tax Evasion in Different Countries

The following contains a brief about the tax evasion concept in different countries.

(i) United Arab Emirates

In early October 2021, 11.9 million leaked financial records in addition to 2.9 TB of data was released in the name of Pandora Papers by the International Consortium of Investigative Journalists (ICIJ), exposing the secret offshore accounts of around 35 world leaders in tax havens to evade taxes. One of the many leaders to be exposed was the ruler of Dubai and prime minister of the United Arab Emirates, Sheikh Mohammed Bin Rashid Al-Maktoum. Sheikh Mohammed was identified as the shareholder of three firms that were registered in the tax havens of Bahamas and British Virgin Islands through an Emirati company, partially owned by an investment conglomerate, Dubai Holding and Axiom Limited, major shares of which were owned by the ruler.

As per the leaked records, the Dubai ruler owned a massive number of upmarket and luxurious real estate across Europe via the cited offshore entities registered in tax havens.

Additionally, the Pandora Papers also cites that the former Managing Director of IMF and French finance minister, Dominique Strauss-Kahn was permitted to create a consulting firm in the United Arab Emirates in 2018 after the expiry of tax exemptions of his Moroccan company, which he used for receiving millions of dollar worth of tax free consulting fees.

(ii) Germany, France, Italy, Denmark, Belgium

A network of banks, stock traders and top lawyers has obtained billions from the European treasuries through suspected fraud and speculation with dividend tax. The five hardest hit countries have lost together at least $62.9 billion. Germany is the hardest hit country, with around €31 billion withdrawn from the German treasury. Estimated losses for other countries include at least €17 billion for France, €4.5 billion in Italy, €1.7 billion in Denmark and €201 million for Belgium.

(iii) Scandinavia

A paper by economists Annette Alstadsæter, Niels Johannesen and Gabriel Zucman, which used data from HSBC Switzerland ("Swiss leaks") and Mossack Fonseca ("Panama Papers"), found that on average about 3% of personal taxes are evaded in Scandinavia, but this figure rises to about 30% in the top 0.01% of the wealth distribution. Taking tax evasion into account increases the rise in inequality seen in tax data since the 1970s markedly, highlighting the need to move beyond tax data to capture income and wealth at the top, even in countries where tax compliance is generally high. We also find that after reducing tax evasion—by using tax amnesties—tax evaders do not legally avoid taxes more. This result suggests that fighting tax evasion can be an effective way to collect more tax revenue from the ultra-wealthy.

(iv) United Kingdom

HMRC, the UK tax collection agency, estimated that in the tax year 2016–17, pure tax evasion (i.e. not including things like hidden economy or criminal activity) cost the government £5.3 billion. This compared to a wider tax gap (the difference between the amount of tax that should, in theory, be collected by HMRC, against what is actually collected) of £33 billion in the same year, an amount that represented 5.7% of liabilities. At the same time, tax avoidance was estimated at £1.7 billion (this does not include international tax arrangements that cannot be challenged under the UK law, including some forms of base erosion and profit shifting (BEPS)).

In 2013, the Coalition government announced a crackdown on economic crime. It created a new criminal offence for aiding tax evasion and removed the requirement for tax investigation authorities to prove "intent to evade tax" to prosecute offenders.

In 2015, Chancellor George Osborne promised to collect £5 bn by "waging war" on tax evaders by announcing new powers for HMRC to target people with offshore bank accounts. The number of people prosecuted for tax evasion doubled in 2014/15 from the year before to 1,258.

(v) United States

In the United States of America, Federal tax evasion is defined as the purposeful, illegal attempt to evade the assessment or the payment of a tax imposed by federal law. Conviction of tax evasion may result in fines and imprisonment.

The Internal Revenue Service (IRS) has identified small businesses and sole proprietors as the largest contributors to the tax gap between what Americans owe in federal taxes and what the federal government receives. Small businesses and sole proprietorships contribute to the tax gap because there are few ways for the government to know about skimming or non-reporting of income without mounting significant investigations.

As of 2007 the most common means of tax evasion was overstatement of charitable contributions, particularly church donations.

2.3. Tax Evasion and Inequality

Generally, individuals tend to evade taxes, while companies rather avoid taxes. There is a great heterogenic among people who evade people as it is a substantial issue in society that is creating an excessive tax gap. Studies suggest that 8% of global financial wealth lies in offshore accounts. Often, offshore wealth that is stored in tax havens stays undetected in random audits. Even though there is high diversity among people who evade taxes, there is a higher probability among the highest wealth group. According to Johannesen and Zucman 2019, the extent of taxes evaded is substantially higher with higher income, and exceptionally higher among people of the top wealth group. In line with this, the probability to appear in the Panama Papers rises significantly among the top 0.01% of the wealth group, as does the probability to own an unreported account at HSBC. However, the upper wealth group is also more inclined to use tax amnesty.

2.4. Common Forms of Tax Evasion

Following are the common forms of Tax Evasion:

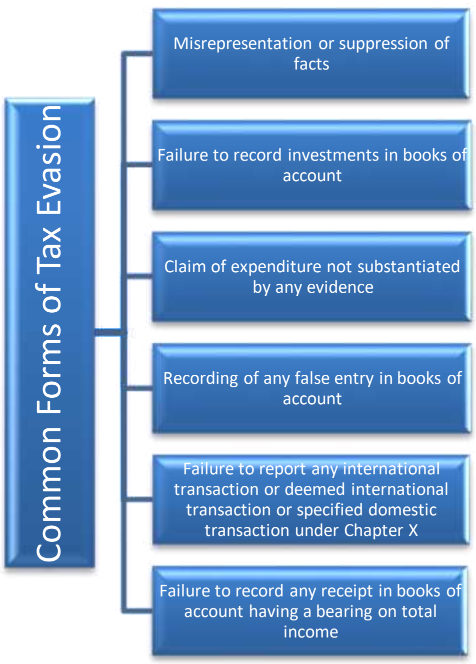

Fig. Common Forms of Tax Evasion

The above mentioned acts result into misreporting of income which attract penalty @ 200% under section 270A.

3. Tax Avoidance

Tax avoidance is the process of reducing the tax payable, given the deductions applicable to taxpayers. It helps reduce the tax burden of individuals and businesses, including major corporates. Avoiding taxes is a legal way of decreasing the tax liabilities of a citizen or business unit in an economy.

Tax avoidance is different from tax evasion, which involves illegal ways of getting rid of the tax responsibilities or conducting tax frauds. Though it is completely ethical to keep the taxes as minimum as possible using this avoidance process, it is still not recommended as it increases the tax burden for everyone else in the nation.

3.1. Tax Avoidance Framework

Tax avoidance helps individuals and entities adopt legal ways of avoiding their tax liabilities. This is achieved through deductions and credits that an economy allows to the taxpayers. In addition, individuals can prevent tax loads by making tax-advantaged investments, including 401(k) scheme and Individual Retirement Accounts (IRAs).

Every country has a specific tax law to determine the legal ways of tax avoidance. Depending on those provisions, the individuals and businesses decide how to lower their tax liabilities. The motive behind introducing the tax avoidance schemes is to encourage people's expenditure on different savings and other charitable initiatives, which people ignore most of the time.

In the attempt to pay less income tax, the individuals and entities try spending more amounts into the savings schemes, deducting a portion of their taxable amount to a significant limit. The process is a legitimate way of reducing the tax burden, but it leads to reduced revenue collection for the governments of respective nations. As a result, the tax authorities have to impose extra tax liabilities on the rest of the population to compensate for the losses.

Though it is necessary for taxpaying individuals and businesses to adopt these legal means of avoiding taxes, some might take unfair advantage of it by implementing new ways of avoiding tax liabilities with respect to the legal limits.

Following are the examples to understand Tax Avoidance in a better manner:

Example 1:

Sarah had an average gross income and is left with service tenure of 10 years. Hence, she decides to save for her retirement in the Saver's Credit account. Thus, she starts saving Rs. 1000 in the account for a financially stable retirement phase. This makes her eligible for a tax credit of up to half the contribution she made for the plan.

Example 2:

Mr. X, Y & Z have the same gross income, but they pay different amounts of tax, and their take-home salaries also differ. The reason is the difference between their contributions to various accounts. Let us assume tax rate to be 30% on Taxable Income.

	Particulars	**X (in Rs.)**	**Y (in Rs.)**	**Z (in Rs.)**
A	Gross Income	70,000	70,000	70,000
B	Social Security	6,000	12,000	18,000
C	Mediclaim	7,000	7,000	7,000
D	Life Insurance	4,500	4,500	4,500
E	State Tax	320	320	320
F = A - (B + C + D + E)	Taxable Income	52,180	46,180	40,180
G = F*30%	Tax	15,654	13,854	12,054
H = F - G	Take Home salary	36,526	32,326	28,126

The table above shows that Mr. Y's take-home salary is reduced by Rs. (36,526 – 32,326) = Rs. 4,200 as he increases his contribution to the retirement funds by Rs. 6,000. On the other hand, the take-home salary of Mr. X is more, but his retirement fund contribution is less, which would mean a lesser income during retirement.

3.2. Methods of Tax Avoidance

There are various tax avoidance strategies to ensure taxpayers save on their income taxes and make their tax planning accordingly. Some of them have been listed below:

(i) Savings

Spending on employer-sponsored savings schemes keeps individuals open to tax deductions. For example, IRAs help employees save a portion of their gross income to ensure a happy retirement life and let them enjoy significant tax benefits. For example, US citizens can contribute up to $19,000 to a 401(k) scheme if they are below 50 and up to $25,000 if they are 50 and above.

(ii) Deductions

The expenses that remain non-reimbursed could be filed and claimed under the annual tax return. However, this applies to only a specific set of workplace expenses, which are a must for employees to keep performing. Some such expenses include union dues, tools, personal conveyances, etc.

(iii) Investments

The governments allow deductions for investment in certain funds. For example, the mortgage payments are subject to offering tax benefits to the concerned investors. So, taxpayers must ensure making an investment that helps them enjoy some tax deductions. Home equity comes with tax-deductible interest. Individuals are allowed an amount to a limit, depending on their income, which could be used for annual deduction.

(iv) Start-up

One of the most efficient tax avoidance methods is to have a start-up, as business expenses tend to offer huge tax benefits to individuals. This is because the tax authorities allow all the business-related expenses for tax deductions. However, no personal expenses are included.

(v) Health Scheme

Expenditures made for paying health, medical, and dental premiums offer tax-deductible advantages to the insurance holders and their dependents. The Health Savings Account (HSA) is a plan that allows individuals to enjoy major tax benefits. One can make payments for health and medical expenses using the insurance coverage and add it to the tax deduction list.

(vi) Tax Credit

The tax authorities let taxpayers claim for tax credits, which sometimes equate to a zero tax liability. This makes tax credit one of the best tax avoidance types for individuals and businesses. The Internal Revenue Service (IRS) has introduced multiple tax credits for taxpayers to claim. Some of these include the Earned Income Tax Credit, Advance Child Tax Credit, Energy Tax Incentives, Tax Relief in Disaster Situations, Federal Tax Deductions for Charitable Donations, etc.

Fig. Methods of Tax Avoidance

3.3. Advantages of Tax Avoidance

The benefits of Tax Avoidance are as follows:

(i) It increases income and savings for individuals and business entities both for present and future.
(ii) It leads to betters working capital availability.
(iii)It enhances savings tendency.
(iv)It also offers tax shelter opportunities.
(v) It provides an ethical way of fulfilling obligations

3.4. Disadvantages of Tax Avoidance

The limitations that the process puts on tax authorities include the following:

(i) It decreases government revenue.
(ii) It reduces nation's growth rate on the nation.
(iii)It increases government intervention.
(iv)It has more stricter tax policies.
(v) It is more government-friendly than citizen-friendly.

3.5. Tax Avoidance vs. Tax Exemption

Tax avoidance and tax exemption might sound similar, but they are different in many aspects. Though both the processes reduce the tax amount, they differ in legal terms. While tax avoidance is a legal way of reducing the tax to be deducted from the gross income, tax evasion is an unethical and illegal way of skipping tax payments.

Individuals and businesses get an opportunity to avoid taxes by utilizing tax shelters. It means they are free to invest in tax-advantaged schemes and initiatives. On the contrary, evading taxes involves sandbagging techniques where individuals and institutions falsify deductions by underreporting the gross income.

4. Tax Mitigation

Tax mitigation is a way of ensuring that tax affairs are properly structured so that a person doesn't pay any more tax than a person should. In the UK, there are a number of methods which allows a person to legitimately do this, and a range of allowances available to help reduce or even eliminate your tax bill.

Tax mitigation is a legitimate method of safeguarding tax position – and reducing tax bill. There are lots of ways to achieve tax mitigation through the use of financial schemes including pensions, inheritance tax and succession planning, capital gains tax allowances and so on.

Tax mitigation and tax avoidance are terms which have different meanings. Tax mitigation is an acceptable practice to help reduce tax bill. Tax avoidance tends to involve the use of specific loopholes in the law, such as tax havens or tax shelters to help reduce the tax bill. As a result tax avoidance is likely to be viewed much more negatively, given its association to exploit the tax system for personal gain.

Tax evasion usually refers to dishonest or illegal arrangements, where the amount of tax which is due in a particular country isn't paid either in full or in part. This can take different forms but tends to involve funds or information being deliberately hidden from the relevant tax authority.

As a result, any tax liability is reduced using fraudulent practices. In recent years many tax jurisdictions, including the UK, have taken significant steps to share information to help combat tax evasion. Much of the focus by the UK tax authorities has been on buy-to-let property purchased by overseas investors who have failed to declare rental income. HMRC also uses data from tax authorities in other countries who collectively use the Common Reporting Standard (CRS) to gather information.

When considering a tax mitigation plan it can be useful to take into account some of the ways in which tax can be legitimately reduced. This might involve working out which of the UK taxes apply based on residence and domicile status, and how allowances and exemptions might apply.

4.1. Ways of Tax Mitigation

There are a number of ways in which a person can legally mitigate the tax bill including:

i) Proper use of allowances available in the tax laws applicable to the assessee.
ii) It's sensible for any assets which produce income and gains to be owned in such a way that any positive returns take place in the hands of asseessee who pay tax at the lower rates. For example, if one spouse is a high earner and the other spouse does not have any income, perhaps consider structuring any investment portfolio so that investment income and gains occur in the hands of the spouse who has the available tax allowances and lower rate tax bands.
iii) There are investments that produce income and gains which are taxed at lower rates or which may actually be free of tax. In addition it may be possible to hold investments inside structures and wrappers which offer protection from tax for those investments.
iv) Saving for retirement offers a couple of ways to reduce the tax bill. Firstly, any pension contributions made will be free of income tax. And it can also reduce the taxable income with pension contributions too if the employer offers a salary sacrifice scheme.
v) An employee may also be able to reduce their tax bill by claiming relief on any expenses which is incurred as a direct result of the job. This might include specialist clothing, professional fees and subscriptions, travel and subsistence or the additional costs of working from home.

5. Tax Planning

Tax planning involves an intelligent application of the various provisions of the direct tax laws to practical situations in such a manner as to reduce the tax impact on the assessee to the minimum. A thorough understanding of the principles, practices and procedures of tax laws and the ability to apply such knowledge to various practical situations is expected at the final level.

A thorough up-to-date knowledge of tax laws is a pre-requisite for a successful study of tax planning techniques. Not only an up-to-date knowledge of the statute is necessary, but one must also be aware of the contents of the various circulars issued by the CBDT and also of case laws in the form of various decisions of the Courts. One of the best methods to study tax planning in action is to analyse the case laws. In view of this position, one should realise the importance and usefulness of keeping track of the judgments of Supreme Court and of various High Courts reported in tax law journals from time to time. One should make it a point to go through the relevant cases and understand the issues involved and the rationale of the judgments. Of course, tax planning in a particular case would depend on the facts and circumstances of that particular case.

Apart from the above, one is advised to go through the articles on tax laws published in tax journals and financial papers. With this brief introduction, some of the basic concepts of tax planning are mentioned.

Before entering into a transaction or before starting a business, one normally considers its profitability and other aspects. Amongst other aspects, the tax implications of the transactions of the business have to be thought out before actually embarking on the deal. Otherwise one may be caught unwittingly in huge tax liability. Planning from the point of view of taxation helps in generating greater savings of investible surplus.

Tax planning may be defined as an arrangement of one's financial affairs in such a way that, without violating in any way the legal provisions, full advantage is taken of all tax exemptions, deductions, concessions, rebates, allowances and other reliefs or benefits permitted under the Act so that the burden of taxation on the assessee is reduced to the minimum.

It involves arranging one's financial affairs by intelligently anticipating the effects which the tax laws will have on the arrangements now being adopted. As such it is a very stimulating intellectual exercise.

Any tax planning scheme should be a natural one and should not give an appearance of an artificial arrangement on the face of it. The tax planner or the tax adviser should exercise great care and caution in designing any tax planning scheme as its failure will result in great difficulties and heavy burden of tax on the assessee for whom the scheme is evolved.

5.1. Types of Tax Planning

There are two types of tax planning:

(i) Short-Range Tax Planning
(ii) Long-Range Tax Planning

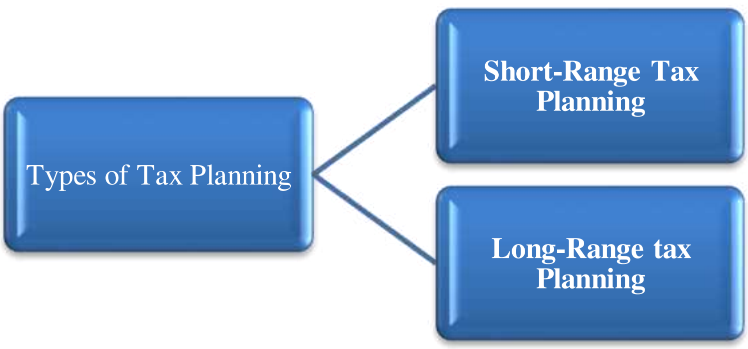

Fig. Types of Tax Planning

Short-range tax planning: The short-range tax planning has limited objective. An assessee whose income is likely to register unusual growth in a particular year on account of say, sale of capital asset like house property, as compared to the preceding year might plan to invest the same in notified bonds, bonds of National Highway Authority of India or Rural Electrification Corporation Limited to claim exemption under section 54EC. This has a lock-in period of 5 years. Such a plan does not involve any permanent or long-term commitment and yet it results in substantial tax saving. This is an example of short-range tax planning.

Long-range tax planning: The long-range tax planning, on the other hand, may not even confer immediate tax benefits. However, it may pay-off in none too distant a future. For instance, in a case where an assessee transfers certain shares to his spouse, the income arising from the shares will, of course, be clubbed with the transferor's income. However, if the company subsequently issues bonus shares in respect of those shares, the income arising from the bonus shares will not be clubbed with the transferor's income. Similarly, the income arising out of the investment of the income from the transferred assets will not also be clubbed with the transferor's income. Long range tax planning may be resorted to even for domestic or family reasons.

In relation to income-tax, the following may be noted as illustrative instances of tax-planning measures:

(a) Varying the residential status taking into consideration the number of days of stay in India to be a resident, in case of an individual.
(b) Choosing the suitable form of assessable entity (individual, HUF, firm, co-operative society, association of persons, company, trust, etc. to obtain optimal tax concessions)
(c) Choosing suitable forms of investment (share capital, loan capital, lease, mortgages, tax exempt investments, priority sector, etc.), considering deductions available in respect of interest or dividend etc.
(d) Programmed replacement of assets to take advantage of the provisions governing depreciation.
(e) Programmed sale of capital assets depending upon the period of holding and deductions specifically available for assets held for long term.
(f) Diversification of the business activities (hotel industry, agro-based industry etc.) considering the various profit-linked and investment-linked benefits available under the provisions of the Act.
(g) The use of the concept of commercial expediency to claim deduction in respect of expenditure, in computing business income.

5.2. Tests to be Satisfied for a Successful Tax Planning

Tax planning in any case will entirely depend on the individual facts and circumstances. It is a tool in the hands of the taxpayer and tax practitioners for selective use.

It is essential to comprehend:

(a) that the facts bearing on the issue are evidenced by proof;

(b) that the associated legal consequences, both under the personal and under the tax laws, are fully borne in mind; and
(c) that the situation warrants implementation of "tax planning".

Successful tax planning must conform to two outstanding tests viz,
(a) conformity with the current law and
(b) flexibility.

In order to satisfy the first test, the essential requisite is a comprehensive knowledge of the law, rules and regulations on the part of the tax planner. This knowledge of law extends not only to the provisions of the taxing statutes and the case law that has developed on those statutes, but also to other branches of law, both civil and personal, so that the tax planner's device does not get defeated by the universal principles of jurisprudence.

The second test of flexibility seeks to ensure that the success of the tax planning device is not nullified by statutory negation. Though the tax planner may be successful in seeking out a device which in his opinion is in conformity with law, the subsequent statutory negation may nullify his success. In order to counter this exigency, his tax plan must be flexible. Flexibility essentially means that the device provides for suitable changes in accepted forms. Flexibility is a practical concept. Its introduction and utilisation depend upon the circumstances of the case. Under certain circumstances, flexibility may be of no avail. As a matter of fact, flexibility may invalidate the tax plan. But when flexibility is permissible, the tax planner will do well to remember to keep this test in mind to counter the measures of statutory negation. In view of this position wherever possible, tax planning schemes should be flexible, designed so as to avoid irretrievable situations. The tax planner should, therefore, be watchful of all significant developments related to his field.

In order to be a successful venture, efforts at tax planning should not ignore the legislative intent; they should be directed in every case to see that not only the tax benefits are obtained but also the tax obligations are discharged without fail so that the penal provisions are not attracted.

5.3. Tax Planning and Doctrine of Substance over Form

One of the reasons which prompts a taxpayer to resort to tax planning is the existence of the doctrine of form and substance. The principle involved in this doctrine is simple. It is to be determined how far the Court can stretch the wording of a Statute to cover a particular set of facts, where those facts have clearly been created by a tax payer in order to avoid or minimise his tax and the literal interpretation of the Statute is not, at first sight apt to cover them. Further it is to be resolved whether it is possible to ignore the form of a transaction and determine the substance thereof.

Landmark Judgments wherein doctrine of form and substance played a major role in decision making:

(i) In **Commissioner of Income tax vs. Motor and General Stores (P) Ltd. (1967) 66 ITR 692**, the Supreme Court had observed that in the absence of any suggestion of bad faith or fraud the true principle is that the taxing statute has to be applied in accordance with the legal rights of the parties to the transaction. According to the court, when the transaction is embodied in a document the liability to tax depends upon the meaning and content of the language used in accordance with the ordinary rules of construction. The House of Lords in **Duke of Westminster vs. ICR (1936) 19 ATC 498** held that in considering the substance of the transaction, the legal form cannot be disregarded.

(ii) It was held in **CIT vs. B.M. Kharwar (1969) 72 ITR 603 (SC)** that the taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by device the legal relation, it is open to the taxing authority to unravel the device and to determine the true character of the relationship. However, the legal effect of a transaction cannot be displaced by probing into 'the substance of the transaction'. This principle applies alike to cases in which the legal relation is recorded in a formal document and to cases where it has to be gathered from the evidence - oral and documentary - and the conduct of the parties to the transaction. However, this view of the Supreme Court has now been expressly disapproved by the Supreme Court in Mc Dowell & Co. Ltd.'s case.

(iii) Justice Shah, in **Ram Laxman Sugar Mills vs. CIT (1967) 66 ITR 613, 617 (SC)**, has stated that to ascertain the legal effect of a transaction, the court seeks, in the first instance, to determine the intention of the parties and if ambiguous expressions are used, the court may normally adopt such interpretation consistent with the parties thereto having acted on the assumption of its validity. Thus, any claim made by a taxpayer will be scrutinized from the point of view of his intention and if there was any intention to defraud the revenue, the court will consider the transaction or the claim as fraud.

Thus, we can say that unless there is clear evidence of malafide intention resulting in a form which is a "colorable device" or "mere legal facade" or "non-genuine" form the tax authorities are not justified in disregarding the legal form and probing into the substance of the transaction.

Principles governing the form and substance: Theory of interpretation of a taxing statute:

i) It is well settled that when a transaction is arranged in one form known to law, it will attract tax liability while, if it is entered into in another form which is equally lawful, it may not. In considering, therefore, whether a transaction attracts tax or not, the form of the transaction put through by the assessee is to be considered and not the substance thereof.

ii) The above rule cannot naturally apply where the transaction, as put through by the assessee, is not genuine but colourable or is a mere device. For here, the question is not one between ‘form’ and ‘substance’ but between appearance and truth.

iii) In deciding whether the transaction is a genuine or colourable one, it will be open to the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction.

iv) Where the authorities are charged under the Act with the duty of determining the nature or purpose of and payment or receipt on the facts of a case, it is open to them to work at the substance of the matter and the formal aspect may be ignored.

v) Where the terms of a transaction are embodied in a document, it should not be construed only in its formal or technical aspect. While the words used should be looked at, too much importance should not be attached to the name or label given by the parties and the document should be interpreted so as to accord with the real intention of the parties as appearing from the instrument.

The decisions of the Supreme Court in the cases of Mc Dowell, Karthikeya Sarabhai and Associated Rubber Industries, clearly show a preference for the ‘substance’ over the ‘form’, if the circumstances of the case warrant such a preference. Where the transactions are genuine, perfectly authentic and not sham, the mere fact that the transaction results in less liability or no liability to tax should not put the transaction to a legal scrutiny questioning the substance of the transaction, attributing a motive behind it. It is up to the Court to take stock of the situation, weigh out sophisticated legal devices and expose the devices for what they really are.

5.4. Tax planning in respect of Salary

The scope for tax planning from the angle of employees is limited. The definition of salary is very wide and includes not only monetary salary but also benefits and perquisites in kind. The only deductions available in respect of salary income are the standard deduction upto Rs. 50,000, deduction for entertainment allowance and deduction for professional tax. Therefore, the scope for tax planning in respect of salary income is severely limited. However, the following are some ideas of tax planning in regard to salary income.

(1) Salary Structure: The employer should plan the salary structure keeping in view the deductions and exemptions available under the Act. If salary is paid as a consolidated amount, without any break-up, the amount of salary after providing standard deduction of Rs. 50,000, would become taxable without any further exemption and deduction. Therefore, the employer should split the same and pay it as basic salary plus various allowances and perquisites, so as to reduce the tax implication in the hands of the employee.

For example, the employer may include allowances as part of the salary structure of the employees for which exemption can be claimed under Rule 2BB, eg. Children education allowance, hostel allowance, house rent allowance. The employer will get a deduction of all the above amounts paid while computing his profits and gains of business or profession.

Further, the employer can give such allowances like special compensatory allowance, border area allowance or remote area allowance or difficult area allowance or disturbed area allowance depending upon the posting of the employee. Some exemptions are available in respect of these allowances. In this connection, Rule 2BB specifies the exempt allowances. The employer has to make a careful study and fix the salary structure in such a manner that it will include allowances which are exempt.

Standard deduction of Rs. 50,000 or the amount of gross salary, whichever is less, is allowed as deduction under section 16(ia).

(2) Employees' Welfare Schemes: There are several employees' welfare schemes such as recognised provident fund, approved superannuation fund, gratuity fund. Payments received from such funds by the employees are totally exempt or exempt upto significant amounts.

For example, gratuity received by an employee covered under the Payment of Gratuity Act, 1972 is exempt upto Rs. 20 lakh. The entire provident fund received by the employee from recognised provident fund is exempt. The employer is well advised to institute such welfare schemes for the benefit of the employees. Such amount contributed by the employer towards the above funds is deductible. However, a note of caution is necessary here in view of the restrictive provisions of section 40A(9) which disallows any contribution made to any welfare funds except where such contributions are covered by section 36(1)(iv)/(iva)/(v) or as required by or under any other law for the time being in force. In this connection, it may be noted that section 10(23AAA) exempts any income of a staff welfare fund subject to the satisfaction of certain conditions. However, in the absence of an amendment to section 40A(9), contribution to such welfare trusts can be disallowed by the Assessing Officer. Further, the employer can contribute to recognized provident fund account of the employee upto 12% of salary, and the same would not be taxable in the hands of the employees. The amount or aggregate of amounts of any contribution made in a recognised provident fund, in NPS referred to in section 80CCD(1) and in an approved superannuation fund by the employer to the account of the assessee, to the extent it exceeds Rs. 7,50,000, would be taxable as perquisite in the hands of the employee.

(3) Insurance Policies: Any payment made by an employer on behalf of an employee to maintain a life policy will be treated as perquisite in the hands of the employee. Further, payments received from the employer in respect of keyman insurance policies constitute income in the hands of the employees. However, the payment of premium by the employer on behalf of the employee will not be treated as a perquisite in the case of accident insurance policies. This is due to the fact that the employer has a vested interest in the safety of the life of his employee who is engaged in such dangerous occupations. **[CIT v Lala Shri Dhar (1972) 84 ITR 192 (Del) and CIT v Vinay Bharat Ram (1981) 129 ITR 128 (Del)]**. Further, any sum paid by the employer in respect of any mediclaim premium paid by the employee to keep in force an insurance on his health or the health of any member of his family under any scheme approved by the Central Government or IRDA for the purpose of section 80D is not a perquisite in the hands of the employee.

(4) Dearness Allowance, Dearness Pay: The employer should ensure that dearness allowance and dearness pay should form part of "salary". This is because certain items like entertainment allowance, gratuity, commuted pension and the employer's contribution to the recognised provident fund etc. are calculated on the basis of salary. Therefore, if dearness allowance, dearness pay etc. are included in salary, the above benefits will also increase leading to higher exemption in the hands of the employee.

(5) Commission: The Supreme Court, in **Gestetner Duplicators Pvt. Ltd. v. CIT 117 ITR 1**, has held that if, under the terms of employment, commission is payable at a fixed percentage of turnover achieved by an employee such commission should be taken into account for calculating "salary" for the purpose of gratuity etc. The employer will be well advised to provide for such commission.

(6) Leave Travel Facility: The employer should extend leave travel facility to the employees at all levels. Under section 10(5) of the Income-tax Act, 1961, exemption is provided in the hands of the employee in respect of leave travel concession. Such exemption is available for the employee, spouse, children (to a maximum of 2 children), dependent parents, dependent brothers and dependent sisters.

(7) Rent Free Accommodation/ House Rent Allowance (HRA): An employee should analyse the tax incidence of a perquisite and an allowance, whenever he is given an option, in order to choose the one which is more beneficial to him. In the case of Rent Free Accommodation vs. HRA, it must be noted that the perquisite of rent free accommodation is taxed as per Rule 3(1) of the Income-tax Rules, 1962 and HRA is exempt to the extent mentioned in section 10(13A) read with Rule 2A. The employee should therefore work out his tax liability and net cash flow under both the options and then, decide on whether to receive HRA or choose a rent free accommodation.

(8) Uncommuted/Commuted Pension: Uncommuted pension is fully taxable. Therefore, the employees should get their pension commuted. Commuted pension is fully exempt from tax in the case of government employees and partly exempt from tax in the case of non-government employees.

(9) Provident Fund: Accumulated balance due and becoming payable to an employee participating in a Recognized Provident Fund (RPF) would be exempt, where an employee who is a member of a recognised provident fund and who resigns after completing five years of continuous service. However, he resigns before completing five years of continuous service he should ensure that he joins a firm which maintains a recognised provident fund. The accumulated balance of the provident fund with the previous employer will be exempt from tax provided the same is transferred to the new employer who also maintains a recognised provident fund.

It may be noted the exemption would not be available in respect of income by way of interest accrued during the previous year to the extent it relates to the amount or the aggregate of amounts of contribution made by that person/employee exceeding Rs. 2,50,000 in any previous year in that fund, on or after 1st April, 2021 and computed in prescribed manner.

(10) Retirement Benefits: Incidence of tax on retirement benefits like gratuity, commuted pension, accumulated balance of unrecognized provident fund is lower if they are paid in the beginning of the financial year.

The employer and the employees should mutually plan their affairs in such a way that retirement takes place in the beginning of a financial year.

(11) Pension received by Non-Residents: Pension received in India by a non-resident assessee from abroad is taxable in India. If, however, such pension is first received by or on behalf of the employee in a foreign country and later on remitted to India, it will be exempt from tax.

(12) Accident Insurance: In respect of accident insurance policies, the decision of the Supreme Court in **CIT v. L. W. Russel (1964) 53 ITR 91** points out that the term perquisite applied to only such sums in regard to which there was an obligation on the part of the employer to pay and a vested right on the part of the employee. If the employee has no vested interest in the policy, it cannot be considered as a perquisite. In view of this position, in cases where an employer takes out accident insurance policy covering all workmen and staff members and pays insurance premium and whenever any worker/staff member meets with an accident and the amount of claim is received from the insurance company and the same is paid away by the employer to the said worker or his family members, the premium paid by the employer in respect of group accident policies could not be considered as a perquisite, under section 17 to be added in the salary income of any employee **[CIT v. Lala Shri Dhar (1972) 84 ITR 192 (Delhi)]**. The amount received from insurance company on accident or death by employee or his dependents will not also be in the nature of income but a capital receipt and therefore the same will not be taxable.

(13) Tax Free Perquisites: The following are the perquisites which are exempt from tax–

i) Use of computers and laptop by employee;
ii) Medical facility in employer's own hospital or a public hospital or Government or other approved hospital;

iii) Educational benefit in a school run by employer provided value of benefit does not exceed Rs. 1,000 per month per child.

(14) Considerations for Salary Structuring: The perquisite valuation rules prescribe the method for valuing the various perquisites provided by the employer to his employees on the basis of the cost of such perquisites to the employee. For a detailed study, students are advised to refer to the chapter on 'Salaries'. Accordingly, the entire salary structuring for employees will have to be done after carefully weighing the pros and cons of paying salary in monetary terms or allowing the benefit of perquisites in kind to the employees.

It may be noted that a salaried person can opt for concessional rates of tax under section 115BAC in respect of his total income (other than income chargeable to tax at special rates under Chapter XII), if he does not avail certain exemptions/deductions like Leave Travel Concession, standard deduction under the head "Salaries", interest on housing loan on self-occupied property, deductions under Chapter VI-A [other than 80CCD(2) and section 80JJAA] etc.

So, a salaried taxpayer not availing the above deductions/exemptions or availing a lesser amount of such deductions/exemptions can analyse his tax liability under the regular provisions of the Income-tax Act, 1961 vis-à-vis special provisions under section 115BAC. He can choose whether or not to exercise the option in each previous year. An employee intending to opt for concessional rate of tax under section 115BAC has to intimate the same to the employer.

5.5. Some General Considerations in respect of Tax Planning for Business Deductions

There are several matters which affect the assessee's ability to deduct various expenses for income-tax purposes. Some of the principal considerations to be borne in mind planning for business deductions, are given below:

Successful tax planning for business deductions pre-supposes a clear and thorough understanding of the various statutory provisions governing the deductions and an awareness of the statutory rights as well as various restrictions and conditions governing such rights. The general considerations applicable to tax planning in the field of business deductions, revolve round their-

(a) allowability

(b) year of allowability

(c) extent of allowability (disallowing provisions if any), and

(d) carry-forward to future years.

Often, the question of expenditure being capital or revenue and the consequences attaching to the likely treatment eventually may also be an important part of the tax planning exercise.

One of the important aspects of tax planning would be to see that the maximum deduction or allowance is obtained in the earliest possible time for the purpose of determination of taxable income. Therefore, while deciding about incurring of capital and revenue expenditure, the assessee should consider the tax treatment of such expenditures and the period within which the benefit of deduction or amortisation would be obtained so that he can estimate and work out cash flow position over a period of time. While tax considerations play a major role in investment decisions, the general principles of financial management and their effect on investment decisions should not be ignored.

The tax planner should keep in mind the advantage arising out of minimising the expenditure, especially in the initial years of a business, so that the profits may be maximised and the assessee may be in a position to avail of the various tax incentives like depreciation as also the tax holiday provisions.

Normally, deduction for expenditure is allowable in the year in which it is incurred or paid depending on the method of accounting followed, viz, mercantile or cash. In other words, the expenditure to be claimed as deduction should be claimed in the relevant year. Where the assessee follows the cash system of accounting, the allowance in respect of expenses would be available only when the moneys in respect of them are actually paid by the assessee. Whereas in the case of mercantile system of accounting, if a business liability has definitely arisen in the accounting year, a deduction should be allowed. Where accounts are kept on a mercantile basis, if an expenditure is claimed on the ground that it is legally deductible, it can be claimed in the year in which the liability for the expenditure is incurred even though the payment itself is made in a subsequent year. If an assessee following mercantile system fails to claim an expense in the year in which it accrues he loses the right to claim it as a deduction altogether. He cannot claim or make any attempt to reopen the accounts of the earlier year to which the expense relates.

The Supreme Court's decision in **C.I.T. vs. Gemini Cashew Sales Corporation (1967) 65 ITR 643** emphasizes the principle that if the liability to make the payment has arisen during the previous year, it must be appropriately regarded as the expenditure of that year and merely because the payment in respect of the expenditure is made in the subsequent year, the assessee would not be entitled to claim deduction in respect thereof in the subsequent year. As pointed out earlier, this is subject to the provisions of section 43B.

Normally, deduction can be claimed by the assessee only in respect of those expenses and losses which have been actually incurred by the assessee during the previous year, i.e. after the business is set up. However, there are some exceptions to this rule and a tax planner should be aware of the exceptions and make use of them in appropriate cases. For example, expenditure incurred on scientific research before the commencement of the business — capital or revenue during the three years immediately preceding the commencement of the business and coming within the scope of the Explanation to sections 35(1)(i) and 35(1)(ii), capital expenditure incurred prior to commencement of specified business allowed as deduction in the year of commencement of business, in case capitalized under section 35AD, preliminary expenses incurred before commencement of the business and coming within the scope of section 35D, expenditure on prospecting for minerals coming within the scope of section 35E, are cases where the assessee could claim deduction in respect of the expenditure even though the expenditure was not incurred during the previous year.

Similarly, the expenditure in respect of which deduction is claimed by the assessee should not be in the nature of capital expenditure. This is again subject to the statutory exceptions contained in provisions like section 35 and 35AD. Again, subject to the statutory exceptions, the expenditure should be incurred wholly and exclusively for the purpose of the business.

Various other expenses incurred prior to the commencement of commercial operations may, in appropriate cases, be accumulated and capitalised by being spread over the cost of various assets constructed or acquired during the pre-production period. If this is done on a proper basis, the cost of the various assets including the indirect expenses capitalised can be depreciated for tax purposes to the extent that the cost relates to assets which are themselves depreciable for income-tax purposes. This is a matter which the tax planner should bear in mind in order to ensure that expenses incurred during the construction period are properly accounted and allocated.

Under clause (iii) of section 36(1), deduction of interest is allowed in respect of capital borrowed for the purposes of business or profession in the computation of income under the head "Profits and gains of business or profession". As per the proviso to section 36(1)(iii), any amount of interest paid, in respect of capital borrowed for acquisition of an asset for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

ICDS IX on Borrowing Costs deals with the treatment of borrowing costs. It requires borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset to be capitalized as part of the cost of that asset.

Qualifying asset has been defined to mean –

- land, building, machinery, plant or furniture, being tangible assets;
- know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets;
- inventories that require a period of twelve months or more to bring them to a saleable condition.

This ICDS requires capitalization of specific borrowing costs (in respect of funds borrowed specifically for the purpose of acquisition, construction or production of a qualifying asset) and general borrowing costs. In case of qualifying assets being tangible and intangible assets, the capitalization shall commence from the date on which funds were borrowed and cease when such asset is first put to use.

This ICDS also provides the formula for capitalization of borrowing costs when funds are borrowed generally and used for the purpose of acquisition, construction or production of a qualifying asset. For this restricted purpose, a qualifying asset shall be such assets that necessarily require a period of 12 months or more for its acquisition, construction or production. In this case, the capitalization of borrowing costs shall commence from the date on which funds were utilized.

Thin Capitalisation Rules

Equity and debt are the two ways through which a company can source its funding. 'Thin capitalisation' refers to a situation where a company is financed through a substantially higher amount of debt than equity. The capital structure of a company has consequential effects on the amount of profit it reports for tax purposes. The Act allows a deduction on interest paid or payable for arriving at taxable profit while dividend paid on equity is not deductible. Therefore, a higher level of debt entails lower levels of taxable profit, thereby providing an incentive to finance operations with debt rather than equity. Companies structure their mix of finance in such a way that they maximise the benefit of claims of deduction of interest. The Finance Act, 2017 has sought to restrict interest expenses claimed by an Indian company or a permanent establishment of a foreign company on payments to its non-resident associated enterprises (or a permanent establishment thereof) to 30% of earnings before interest, taxes, depreciation and amortization. With a view to targeting only large interest payments, this provision would be applicable only in cases where the interest expense exceeds Rs. 1 crore. Banks and insurance companies have been exempted from these provisions.

5.6. Distinction between Tax Planning, Tax Evasion and Tax Avoidance

The dividing line between tax evasion and tax avoidance is very thin. The Direct Taxes Enquiry Committee (Wanchoo Committee) has tried to draw a distinction between the two items in the following words.

"The distinction between 'evasion' and 'avoidance', therefore, is largely dependent on the difference in methods of escape resorted to.

Tax Planning	• Availing tax exemptions or tax privileges offered by the Government, strictly in accordance with law.
Tax Evasion	• Manoeuvre involving an element of deceit, misrepresentation of facts, falsification of accounting calculations or downright fraud. In simple terms, tax evasion refers to any attempt to avoid payment of taxes by using illegal means.
Tax Avoidance	• Between two extremes i.e., tax planning and tax evasion, a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact, circumvent it with a view to eliminate or reduce tax burden.

Fig. Difference between Tax Planning, Tax Evasion and Tax Avoidance

6. Indian Jurisprudence and Comparative Jurisprudence on Tax Avoidance

The judicial attitude towards tax avoidance schemes is very strict and the landmark judgment of the Supreme Court in **M/s. Mc Dowell and Co. Ltd. vs. Commercial Tax Officer (1985) 154 ITR.148 (SC)** is proof of the same. Though this decision was rendered in the context of A.P. General Sales Tax Act, the principles emerging out of this decision will have relevance to direct taxes also.

Before discussing the relevant observations of the Supreme Court in relation to tax avoidance scheme it will be instructive to have an idea of the development in judicial thinking in England since our own judicial thinking on the subject has been largely derived from English thinking.

English Scene: In **Inland Revenue Commissioner vs. Duke of Westminster 1936 AC 1** it was held "Every man is entitled if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

After the World War II and the consequent huge profiteering and racketeering the attitude of the courts towards the avoidance of tax perceptibly changed and hardened. Commenting on a tax avoidance scheme, the court observed that it scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers.

It was felt that there must be some limit to the devices which courts can put up with in order to defeat the fiscal intentions of the legislature. A very significant departure from the Westminster Principle was made in **Ramsay vs. Inland Revenue Commissioners (1982) AC 300**. It was felt in that case that even though the doctrine that courts could not go behind a given genuine document or transaction to some supposed underlying substance was a cardinal principle, it must not be overstated or over- extended. While obliging the courts to accept documents or transactions, found to be genuine, as such, the doctrine did not compel the court to look at the document or transaction in blinkers isolated from any context to which it properly belonged. If it could be seen that a document or transaction was intended to have effect as a part of a nexus or series of transactions or as an ingredient of a wider transaction intended as a whole, there was nothing in the doctrine to prevent it being so regarded. To do so was not to prefer form to substance or substance to form. It was the task of the court to ascertain the legal nature of any transaction to which it was sought to attach a tax consequence and if that emerged from a series or combination of transactions, intended, apart as such, as was that series or combination which might be regarded.

Thus, two points were established. The first was a significant change in the approach adopted by the court with regard to its judicial role towards tax avoidance scheme. The second was that it was crucial when considering any such scheme to take the analysis far enough to determine where the profit, gain or loss was really to be found. It was also stated that the fact that the court accepted that each step in a transaction was a genuine step producing its intended legal results did not confine the court to consider each step in isolation for the purpose of assessing the fiscal results. Thus, we can say that the true principle of the decision in Ramsay was that the fiscal consequence of a preordained series of transactions intended to operate as such, are generally to be ascertained by considering the result of the series as a whole and not by dissecting the scheme and considering each transaction separately.

In **I.R.C. vs. Burmah Shell Co. Ltd. (1982) STC 30 (Burmah) and Furniss (Inspector of Taxes) vs. Dawson (1984) 1 All E.R.530**, it was held that where tax avoidance was targeted through a series of transactions with no commercial or substantial value but with the only aim of avoiding tax, the Courts have to ignore the transactions and the tax liability has to be determined as if these transactions never took place.

Indian Scenario: In **CIT vs. A. Raman & Co. 1 SCR 10**, the Supreme Court followed the dictum of the Westminster's case. It observed that avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. The taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon consideration of morality but on the operation of the Income-tax Act, 1961. Legislative injunction in taxing statutes may not, except on pain of penalty, be violated but it may lawfully be circumvented. The same view was expressed in **CIT vs. Kharwar (1969) 72 ITR 603 (SC)** as follows:

"The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction, if the parties have chosen to conceal by a device the legal relation, it is open for the taxing authorities to unravel the device and to determine the true character of relationship. The legal effect of a transaction, however, cannot be displaced by probing into the substance of the transaction."

However, the Supreme Court in Mc Dowell's case clearly departed from the above views and expressly disassociated itself with the earlier observations of the Supreme Court echoing the sentiments of Westminster principle. The court enumerated the evil consequences of tax avoidance as follows:

(1) Substantial loss of much needed public revenue.
(2) Serious disturbance caused to the economy of the country by the piling up of mountains of black money, directly causing inflation.
(3) Large hidden loss to the community by some of the best brains of the country involved in perpetual litigation.
(4) Sense of injustice and inequality which tax avoidance arouses in the minds of those who are unwilling or unable to profit by it.
(5) The unethical practice of transferring the burden of tax liability to the shoulders of the guileless, good citizens from those of the 'artful dodgers'.

The court felt that there was as much moral sanction behind taxation laws as behind any other welfare legislation and avoidance of taxation was not ethical.

In the view of the Court, the proper way to construe a taxing statute while considering a device to avoid tax was not to ask whether the provisions should be construed literally or liberally, nor whether the transaction was not unreal and not prohibited by the statute, but whether the transaction was as device to avoid tax and whether the transaction was such that the judicial process might record its approval to it.

The court felt that it was neither fair nor desirable to expect the legislature to intervene and take care of every device to avoid taxation. It was up to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of emerging techniques of interpretation as was done in Ramsay's case to expose the devices for what they are really worth and to refuse to give judicial benediction.

The Supreme Court emphasised that tax planning may be legitimate provided it is within the framework of law and colourable devices cannot be part of tax planning. It is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. The Supreme Court also recommended that it is the obligation of every citizen to pay the taxes honestly without resorting to subterfuge.

It is significant to note that in deciding Mc Dowell's case, the Supreme Court was not content in merely adjudicating the dispute as to whether sales tax was leviable on the Central Excise paid by the purchaser on behalf of the seller and not exhibited in the bill. It also stated in this case that it decided to break away from the long tradition of earlier cases holding that tax avoidance is both legitimate and legal.

Another significant case decided by the Supreme Court, though involving a dispute relating to payment of bonus, is worthy of reference at this stage as it also reflects the same thinking as in Mc Dowell's case. In **Associated Rubber Industries case (1986) 157 ITR 77(SC)**, a new wholly owned subsidiary company was created with no asset of its own except investments transferred by the holding company with no business income, except receiving dividend from the transferred investments. The Supreme Court held that on facts, the purpose of such a transfer of investments was nothing but to reduce the gross profits of the holding company and thereby to reduce the payment of bonus. There was no direct evidence that the subsidiary was formed as a device to reduce the gross profits of the principal company for whatever purpose. But Justice Chinnappa Reddy in passing his judgment was following the principles earlier laid down by him in Mc Dowell's case and was of the opinion that the transfer of shares was nothing but a device like tax evasion to avoid the welfare legislation like the Payment of Bonus Act. It was observed that it is the duty of the Court in every case where ingenuity is expended to avoid liability to taxation and welfare legislation, to get behind the smoke screen and discover the true state of affairs.

The above decision seems to have introduced a new doctrine that it is upto the court to take stock, weigh out sophisticated legal devices and expose the devices for what they really are. The fact that this new doctrine has started gaining ground very fast is seen from a quick succession of decisions, after Mc Dowell in Kartikeya vs. Sarabhai and in Associated Rubber's case. The above change in the trend of judicial thinking clearly shows that the line of demarcation between Tax Planning and Tax avoidance.

In order to curb tax avoidance, provisions such as

(i) applicability of transfer pricing provisions in respect of specified domestic transactions,
(ii) treating any transaction with the person located in the notified jurisdiction areas to be treated as international transaction,
(iii) General Anti-avoidance Rules,
(iv) provisions relating to furnishing of Tax Residency Certificate for claiming benefit of double tax avoidance agreements have been introduced.

The decision in Mc Dowell's case and the subsequent developments has evoked lot of debate in all legal and tax circles. The **Gujarat High Court in CIT vs. Smt. Minal Rameshchandra (1987) 61 CTR (Guj) 80** had occasion to consider the impact of Mc Dowell's case. The following propositions appear to emerge from the same:

i) Mc Dowell's case and observations therein cannot be ignored and these are binding on all courts.
ii) Mc Dowell's case and observation therein should be understood in the context of questioning the legitimacy of use of artificial and transparent device and sham practices to circumvent the law.
iii) Where the arrangement cannot be dismissed as an artificial tax device (and not as a legitimate transaction), the subject can be taxed only having "regard to strict letter of the law and not merely to the spirit of the statute or the substance of the law" and had been consistently laid down earlier. In this sense there is no radical departure from law, prior to Mc Dowell case.

In **C.W.T. vs. Arvind Narottam [1988] 173 ITR 479 (SC)** judge Sabyasachi Mukharji J. made the following significant observations:

i) Where the language of the deed of settlement is plain and admits of no ambiguity there is no scope for considerations of tax avoidance.
ii) One would wish as noted by Chinnappa Reddy in Mc Dowell's case that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary taxpayers very often in a country of shortages (with ostentatious consumption and deprivation for the large masses) ask is does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless waste and ostentation in government spending are avoided or eschewed no amount of moral sermons would change people's attitude to tax avoidance.

iii) Where the true effect on the construction of the deeds is clear, appeal to discourage tax avoidance is not a relevant consideration".

In the light of the above development, we have to ascribe a proper meaning to the concept of tax-planning. We can take a cue from the structure of our tax laws.

Our tax laws tend to serve a dual purpose of collecting revenue and of achieving certain social objectives. There are in-built tax incentives which promote savings and investments in new enterprises and facilitate development of backward areas. A lot of exemptions and incentives are provided in all the direct taxes. If an assessee takes maximum advantage of these incentives, exemptions etc. and enlarges the scope of his disposable resources, there can be no objection because the legislature wants the optimum utilisation of these incentives to promote economic activity in the country. The complexity of our tax-laws makes it impossible for even an intelligent assessee to comprehend them properly and avail all the reliefs which may be genuinely provided by such laws. Moreover, the interaction of other laws such as MRTP Act, FERA, Companies Act etc. make the exercise much more complicated. It requires, therefore, meticulous planning to bring down the tax commitments keeping in view not only the statutes but also the judge-made law. We may say that the above area properly belongs to tax-planning. In this sense there is nothing unethical about tax-planning.

Due to constant changes in the law and new court decisions, it is always necessary to have a continuous review in relation to all matters of tax planning so that appropriate changes are introduced without delay.

It may be noted that the scope of the three English cases of Ramsay, Burmah Oil Company and Dawson have been substantially narrowed by a more balanced view on tax planning in the case of 'Craven vs. White'.

7. General Anti-Avoidance Rules

There is a growing concern amongst the revenue in many countries that taxpayers structure transactions to reduce the tax costs. The Base Erosion and Profits Shifting (BEPS) project of the Organization for Economic Cooperation and Development ("OECD") along with G-20 countries sort to tackle this issue. The BEPS Action plans have come out with various recommendations on the issue, both to address it within the international treaty framework (for example, introducing the principle purpose test, limitation of benefits clause, amending the permanent establishment clause, etc.) and in the domestic tax law context (for example, controlled foreign corporation rules, equalization levy, etc.).

Tax avoidance is not defined in taxing statutes. Tax avoidance is, nevertheless, the outcome of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law as such. International literature on the subject tends to describe it in the following ways:

(i) Tax avoidance involves the legal exploitation of tax laws to one's own advantage.

(ii) Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions in the law.
(iii) An arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.

Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. However, tax authorities internationally consider aggressive tax planning schemes by taxpayers to erode the tax base unnaturally, particularly when effective rates of tax diminish significantly. Several countries have, therefore, legislated to prevent tax avoidance in various ways.

The General Anti-Avoidance Rules (GAAR) provisions aim at combating 'impermissible tax avoidance'. Many countries, like United Kingdom, China, South Africa, Australia, Canada, Brazil have incorporated General Anti-Avoidance Rules in their domestic tax laws to deal with aggressive tax planning.

In India, the GAAR concept was initially introduced in the Direct Taxes Code Bill, 2009 [DTC Bill, 2009]. Later, a Revised Discussion Paper was released. The Direct Taxes Code Bill, 2010 [DTC Bill, 2010] proposed to introduce GAAR from 1st April 2012 onwards. The GAAR provisions were introduced in the Income-tax Act, 1961 vide the Finance Act, 2012 by insertion of new Chapter X-A. Chapter X-A was substituted by the Finance Act, 2013.

The Government subsequently set up a panel under Parthasarathy Shome to review the proposals. The Committee suggested that the rules be deferred by three years to 2016-17, arguing that more time is needed to create administrative machinery for its implementation and called for intensive training of officials.

The Shome Committee Report explains the need for and rationale of GAAR as under:

i) GAAR has been enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form.
ii) Transactions have to be real and are not to be looked at in isolation.
iii) The fact that the transactions are legal, does not imply that they are acceptable with reference to the underlying meaning embedded in the fiscal statute.
iv) Thus, where there is no business purpose except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have comprised part of jurisprudence in direct tax laws as reflected in various judicial decisions.
v) The GAAR provisions codify this 'substance over form' basis of the tax law.

The CBDT, vide Press Release dated January 27, 2017, clarified that the GAAR provisions shall be effective from A.Y. 2018-19 onwards, i.e., financial year 2017-18 onwards. The provisions of GAAR are contained in Chapter X-A of the Income-tax Act, 1961. The necessary procedures for application of GAAR and conditions under which it shall not apply, have been enumerated in Rules 10U to 10UC of the Income-tax Rules, 1962.

Prior to A.Y. 2018-19, the Act contained only Specific Anti-Avoidance Rules (SAARs) to prevent tax avoidance. SAAR targets known tax planning schemes which are commonly used by taxpayers but are not acceptable owing to misuse or abuse of tax laws, or they result in a consequence unintended in the law. In the Act, the following may, inter alia, be considered specific examples of SAAR -

i) Section 40A(2) on excessive or unreasonable payments to related parties not deductible.
ii) Section 80-IA(8) on transactions with tax exempt entities to be valued at market value.
iii) Sections 92 to 92F on transfer pricing regulations applicable to international transactions. These provisions also made applicable to specified domestic transactions by the Finance Act, 2012.
iv) Section 93 on avoidance of tax by transfer of income to non-residents through transfer of assets, rights or interest.
v) Section 94 on avoidance of tax by certain transactions in securities.
vi) Section 94A on transactions with persons located in notified jurisdictions.
vii) Section 2(22)(e) on deemed dividend.
viii) Section 40(a)(i) and (ia) on disallowance of expenses for non-deduction of tax at source.
ix) Section 9 on scope of 'income deemed to accrue or arise in India'. The Finance Act, 2012 had widened its scope to overcome the Supreme Court's ruling in Vodafone and some other cases.
x) Explanations 1 to 13 to section 43(1) on determination of actual cost of assets ignoring agreements, etc., in certain cases.

Tax treaties also provide certain anti-avoidance rules for instance, Limitation of Benefit (LOB) Clause and concept of Beneficial Ownership.

7.1. Applicability of General Anti-Avoidance Rule [Section 95]

i) Section 95 of the Act with regard to the applicability of GAAR provides that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising there from may be determined subject to the provisions of this Chapter.
ii) The section further clarifies that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.
iii) The section starts with a non-obstante clause which means, if there is a conflict with provisions in other sections, then this section shall prevail over other conflicting provisions.

iv) The term arrangement referred to in section 95 of the Act, has been defined in section 102 under clause (1) and means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding;

The term ‘Step’ has been defined in section 102 under clause (9) to include a measure or an action, particularly one of a series taken in order to deal with or achieve a particular thing or object in the arrangement.

7.2. Impermissible Avoidance Agreement [Section 96]

An impermissible avoidance arrangement (IAA) means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and also any of the following tests is satisfied:

a. creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;
b. results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
c. lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or
d. is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes

The **purpose test** of obtaining tax benefit and tainted element test as under clauses (a) to (d) above are twin conditions that satisfy an impermissible avoidance arrangement. The purpose test requires that the main purpose or one of the main purposes is to obtain tax benefit. The term “tax benefit” has been defined in section 102 clause (10) as under -

a. a reduction or avoidance or deferral of tax or other amount payable under this Act; or
b. an increase in a refund of tax or other amount under this Act; or
c. a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or
d. an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or
e. a reduction in total income; or
f. an increase in loss, in the relevant previous year or any other previous year.

The first tainted element refers to non-arm’s length dealings where an arrangement creates rights and obligations, which are not normally created between parties dealing at arm‘s length. As there are specific transfer pricing regulations (SAAR) applicable to international transactions and certain specified domestic transactions, this tainted element is to be examined only in those transactions which are not covered by Transfer Pricing regulations and where the main purpose of the arrangement is to obtain tax benefit.

The second tainted element refers to an arrangement which results in misuse or abuse of the provisions of the Act. It implies cases where the law is followed in letter or form but not in spirit or substance, or where the arrangement results in consequences which are not intended by the legislation, revealing an intent to misuse or abuse the law.

The third tainted element refers to an arrangement which lacks commercial substance or is deemed to lack commercial substance.

The fourth element refers to an arrangement which is entered into, or carried out, by means of, or in a manner which is normally not employed for a bona fide purpose. In other words, it means an arrangement that possesses abnormal features. This is not a purpose test but a manner test.

7.3. Arrangement to Lack Commercial Substance [Section 97]

Another alternate condition of an impermissible avoidance arrangement is that the arrangement lacks commercial substance or is deemed to lack commercial substance in whole or in part.

Under section 97 of Chapter XA of Income-tax Act, 1961, certain arrangements have been deemed to lack commercial substance as under –

(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

(b) it involves or includes—

- (i) round trip financing;
- (ii) an accommodating party;
- (iii) elements that have effect of offsetting or cancelling each other; or
- (iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

(d) it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter)

Clause (a) is the codification of substance v. form doctrine. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed based on the —substance of what took place. In other words, it reflects the inherent ability of the law to remove the corporate veil and look beyond form.

Sub-clause (i) of clause (b) deems an arrangement, which includes round tripping of funds, to lack commercial substance. For this purpose, the phrase round trip financing has been further defined. Round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter), without having any regard to—

- (i) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;
- (ii) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or
- (iii) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

Sub-clause (ii) of clause (b) deems an arrangement which includes an accommodating party to lack commercial substance. For this, the phrase "accommodating party" has been further defined. A party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

It means that where a party is included in an arrangement mainly for obtaining tax benefit to the taxpayer, then such party may be treated as an accommodating party and consequently the arrangement shall be deemed to lack commercial substance. Also, it is not necessary that such party should be connected to the taxpayer.

Sub-clause (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

Sub-clause (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance. In other words, such arrangements have an element of deceit as regards funds.

Clause (c) deems an arrangement to lack commercial substance where it involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose. It means if a particular location is selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance.

In section 97(4), the following factors are considered relevant but not sufficient for determining whether an arrangement lacks commercial substance or not, namely—

(i) the period or time for which the arrangement (including operations therein) exists;
(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;
(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

7.4. Consequence of Impermissible Avoidance Arrangement [Section 98]

If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence may be determined in such manner as is deemed appropriate in the circumstances of the case. Certain illustrations of the manner have been provided, namely:—

(a) disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement;
(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;
(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;
(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;
(e) reallocating amongst the parties to the arrangement—
  (i) any accrual, or receipt, of a capital or revenue nature; or
  (ii) any expenditure, deduction, relief or rebate;
(f) treating—
  (i) the place of residence of any party to the arrangement; or
  (ii) the situs of an asset or of a transaction,
at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or
(g) considering or looking through any arrangement by disregarding any corporate structure.

It has also been provided that –
- (i) any equity may be treated as debt or vice versa;
- (ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or
- (iii) any expenditure, deduction, relief or rebate may be recharacterised.

7.5. Treatment of Connected Persons and Accommodating Party [Section 99]

As per section 99, for the purposes of Chapter X-A, in determining whether a tax benefit exists—
- (i) the parties who are connected persons in relation to each other may be treated as one and the same person;

(ii) any accommodating party may be disregarded;
(iii) such accommodating party and any other party may be treated as one and the same person;
(iv) the arrangement may be considered or looked through by disregarding any corporate structure.

7.6. Framing of Guidelines under Income-tax Rules [Section 101]

The provisions of Chapter XA have to be applied in accordance with such guidelines and subject to such conditions as may be prescribed. These guidelines are contained in Rules 10U to 10UC.

As per Rule 10U, the provisions of General Anti Avoidance Rule are not applicable to:

(a) an arrangement where the tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed a sum of rupees three crores.
(b) a Foreign Institutional Investor -
  (i) who is an assessee under the Act;
  (ii) who has not taken benefit of an agreement referred to in section 90 or section 90A as the case may be; and
  (iii) who has invested in listed securities, or unlisted securities, with the prior permission of the competent authority, in accordance with the Securities and Exchange Board of India (Foreign Institutional Investor) Regulations, 1995 and such other regulations as may be applicable, in relation to such investments.
(c) a person, being a non-resident, in relation to investment made by him by way of offshore derivative instruments or otherwise, directly or indirectly, in a Foreign Institutional Investor.
(d) any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before the 1st day of April, 2017 by such person.

However, the provisions of GAAR shall apply to any arrangement [other than specified in (d) above], irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1st day of April, 2017.

Where a part of an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such part only [Rule 10UA].

The Assessing Officer shall, before making a reference to the Commissioner under section 144BA(1), issue a notice in writing to the assessee seeking objections, if any, to the applicability of provisions of GAAR in his case [Rule 10UB(1)].

Test Your Knowledge

QUESTIONS	
1.	Specify with reason, whether the following acts can be considered as (i) Tax planning; or (ii) Tax management; or (iii) Tax evasion. (i) Mr. X deposits Rs. 1,00,000 in PPF account so as to reduce his total income from Rs. 5,90,000 to Rs. 4,90,000. (ii) ABC Ltd. maintains register of tax deduction at source effected by it to enable timely compliance. (iii) An individual tax payer making tax saver deposit of Rs. 1,00,000 in a nationalised bank. (iv) A partnership firm obtaining declaration from lenders/depositors in Form No. 15G/15H and forwarding the same to income-tax authorities. (v) A company installed an air-conditioner costing Rs. 75,000 at the residence of a director as per terms of his appointment but treats it as fitted in quality control section in the factory. This is with the objective to treat it as plant for the purpose of computing depreciation. (vi) RR Ltd. issued a credit note for Rs. 80,000 as brokerage payable to Mr. Ramana who is the son of the managing director of the company. The purpose is to increase the total income of Mr. Ramana from Rs. 4,20,000 to Rs. 5,00,000 and reduce the income of RR Ltd. correspondingly. (vii) A company remitted provident fund contribution of both its own contribution and employees' contribution on monthly basis before due date.
2.	The merger of a loss making company with a profit making one results in losses setting off profits, a lower net profit and lower tax liability for the merged company. Would the losses be disallowed by applying GAAR?
3.	In continuation to the facts of Question 2 above, let us presume, the profit making company merges with a loss making one. This results in losses setting off profits, a lower net profit and lower tax liability for both companies taken together. Can this be examined under GAAR?
4.	A choice is made by a company by acquiring an asset on lease over outright purchase. The company claims deduction for lease rentals in case of acquisition through lease rather than depreciation as in the case of purchase of the asset. Would the lease rent payment, being higher than the depreciation, be disallowed as expense under GAAR?
5.	M/s Global Architects Inc. is a company incorporated in country F1. It is engaged in the business of providing architectural design services all over the world. It receives an offer from Lovely Resorts Pvt. Ltd., an Indian company, for design and development of resorts all over India.

	India-F1 tax treaty provides that architectural services are technical services and payment for the same to a company may be taxed in India. However, if such professional services are provided by a firm or individual, then payment for such services are taxable only if the firm has a fixed base in India or stay of partners/ employees in India exceed 180 days. Limitation of benefit clause does not exist in tax treaty between India-F1. M/s Global Architects Inc. forms a partnership firm with a third party (director of the company) having only a nominal share in the F1. The firm enters into an agreement to carry out the services in India. The company seconded its trained manpower to the firm. Thus, the partnership firm claimed the treaty benefit and no tax was paid in India. Can such an arrangement be examined under GAAR?
6.	Indco incorporates a Subco in a NTJ (Low Tax Jurisdiction) with equity of US $100. Subco gives a loan of US $ 100 to another Indian company (Z Ltd.) at the rate of 10% p.a. Z Ltd. claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?
7.	Under the provisions of a tax treaty between India and country F4, any capital gains arising from the sale of shares of Indco, an Indian company, would be taxable only in F4 if the transferor is a resident of F4 except where the transferor holds more than 10% interest in the capital stock of Indco. A company, X Ltd., being resident in F4, makes an investment in Indco through two wholly owned subsidiaries (A Ltd. and B Ltd.) located in F4. Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of Indco. The subsidiaries sell the shares of Indco and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

SOLUTIONS

1.

	Answer	Reason
1.	Tax planning	Depositing money in PPF and claiming deduction under section 80C is as per the provisions of law.
2.	Tax management	Maintaining register of payments subject to TDS helps in complying with the obligations under the Income-tax Act, 1961.
3.	Tax planning	Making a tax saver deposit of Rs. 1,00,000 in a nationalized bank for claiming deduction under section 80C by an individual is a permitted tax planning measure under the provisions of income-tax law.
4.	Tax management	Obtaining declaration from lenders/depositors in Form No. 15G/15H by a partnership firm and forwarding the same to Income-tax authorities is in the nature of compliance of statutory obligation under the Income-tax Act, 1961.
5.	Tax evasion	An air conditioner fitted at the residence of a director as per the terms of his appointment would be a furniture qualifying for depreciation @ 10%, whereas an air conditioner fitted in a factory would be a plant qualifying for a higher depreciation @ 15%. The wrong treatment unjustifiably increases the amount of depreciation and consequently, reduces profit and consequent tax liability. Treatment of air-conditioner fitted at the residence of a director as a plant fitted at the factory would tantamount to furnishing of false particulars with an attempt to evade tax.
6.	Tax evasion	Issuance of a credit note for Rs. 80,000 by RR Ltd. as brokerage payable to Mr. Ramana, the son of the Managing Director, to increase his total income from Rs. 4.2 lakh to Rs. 5.00 lakh and to correspondingly reduce the company's total income is a method of reducing the tax liability of the company by recording a fictitious transaction. The company is liable to tax at a flat rate of 30%/ 25%/ 22%, as the case may be, whereas Mr. Ramana would not be liable to pay any tax, since his total income does not exceed Rs. 5,00,000, consequent to which he would be eligible for tax rebate of Rs.

<table>
<tr><td></td><td><table>
<tr><td></td><td></td><td>12,500 under section 87A. Reducing tax liability by recording a fictitious transaction would tantamount to tax evasion.</td></tr>
<tr><td>7.</td><td>Tax management</td><td>Remitting of own contribution to provident fund and employees contribution to provident fund on a monthly basis before due date is proper compliance of the statutory obligations.</td></tr>
</table></td></tr>
<tr><td>2.</td><td>As regards setting off of losses, the provisions relating to merger and amalgamation already contain specific anti-avoidance safeguards. Therefore, GAAR need not be invoked when SAAR is applicable, though as per CBDT Circular No. 7/2017 dated 27.01.2017, GAAR and SAAR can co-exist.</td></tr>
<tr><td>3.</td><td>In case of merger of a profit-making company with loss making company, there are no specific anti-avoidance safeguards. However, since such merger would be under the order of High Court, GAAR would not be invoked if the High Court has explicitly and adequately considered the tax implication while sanctioning the merger scheme.</td></tr>
<tr><td>4.</td><td>GAAR provisions would not apply in this case as the taxpayer merely makes a selection out of the options available to him.</td></tr>
<tr><td>5.</td><td>It is obvious that there was no commercial necessity to create a separate firm except to obtain the tax benefit. The firm was only on paper as the manpower was drawn from the company. The firm did not have any commercial substance. Moreover, it is a case of treaty abuse. Hence, GAAR may be invoked to disregard the firm and tax payment for architectural services as fee for technical services. However, the rate of tax on such payment shall be as applicable under the treaty, if more beneficial.</td></tr>
<tr><td>6.</td><td>The arrangement appears to avoid payment of tax on interest income by Indco in case loan is directly provided by Indco to Z Ltd. The arrangement involves round tripping of funds even though the funds emanating from Indco are not traced back to Indco in this case. Hence, the arrangement may be deemed to lack commercial substance.

Consequently, in the case of Indco, Subco may be disregarded and the interest income may be taxed in the hands of Indco.</td></tr>
<tr><td>7.</td><td>The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor X Ltd. in any manner (i.e. on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement can be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring A and B, the two subsidiaries, or by treating A and B as one and the same company for tax computation purposes.</td></tr>
</table>

Module II – Limitation of Existing Tax Treaties

6. Introduction

There are more than 3,000 bilateral tax treaties in effect, most of which are based on models from the OECD and the United Nations. They're essentially agreements between two countries that allow individuals and corporations to avoid the double taxation of income.

Tax treaties can be used in countless situations, from calculating the home- and host-country income taxes of expatriate workers to determining whether a multinational corporation has created a taxable presence in a jurisdiction.

Tax treaties in general only affect federal-level taxation. It is always important to keep in mind the state tax implications of any transaction, because they may differ significantly from federal treatment, particularly with respect to cross-border transactions.

Tax treaties, then, can provide significant benefits to corporations in numerous situations but treaty rules are complicated and compliance is more important than ever. Tax authorities around the world are intent on eliminating treaty shopping, as the OECD's BEPS program attests. Multinational groups that fail to fully understand and comply with limitations on benefits and other tax-treaty restrictions are at risk of severe tax penalties and widespread reputational damage.

7. Treaty Override

In most countries, treaties (including tax treaties) have a status superior to that of ordinary domestic laws. However, in some countries, there have been instances of treaties being changed unilaterally by subsequent domestic legislation. In this context, the term "treaty override" refers to this situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State.

Though well defined in theory, what constitutes a treaty override in practice has always been a matter of debate. The OECD Report attempted to bring some clarity to this issue, by listing certain situations, which either involve or are similar to treaty overrides but should be subject to analysis.

Firstly, a State may legislate to reverse the effect of a court decision, which deviates from the common interpretation of a provision in the text of the treaty. In this case, no injury is considered to have been caused as, in all probability; it is the Court's decision in the first place, which may have been seen overriding the treaty.

In another situation, the State may change the definition of a term used in its domestic legislation, but which is also used in its treaty provision but which is not specifically defined for the purposes of the treaty. In such a case, it is said that there is no override as it cannot have been contemplated that, having once entered into a treaty, a State would be unable to change the definitions of terms used in its domestic law, provided such changes were compatible with the context of the treaty.

Finally, newly enacted domestic legislation may be in conflict with a treaty provision, without the concerned authorities intending, or even being aware of such an effect. This may not constitute a treaty override, as the intention of the legislators, to create a provision in the domestic law that would clearly be in conflict with that State's treaty obligations, is a key element in the formation of the concept of 'treaty override'.

Various authors too, have strived to construe what a treaty override comprises of. The view taken by Professor McIntyre is that 'to violate international law, a breach must be material; and to be material, the breach must take away from a treaty signatory a significant bargained-for benefit and must undermine the objectives of the breached treaty.' In his opinion, such material breaches would constitute a treaty override.

7.1. Position of International Law on Treaty Override

From the international law perspective, tax treaties are given supremacy over domestic law, and as is evidenced by the Vienna Convention on Law of Treaties (VCLT) - the relevant articles of which, clearly condemn treaty override.

Article 26 of the VCLT incorporates the principle of 'Pacta sunt servanda', stating "Every treaty in force is binding upon the parties to it and must be performed by them in good faith."

In addition, Article 27, which talks about internal law and observance of treaties, explicitly states, "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."

Furthermore, Article 18 states the Obligation of a State not to defeat the object and purpose of a treaty prior to its entry into force, and reads as follows:

A State is obliged to refrain from acts which would defeat the object and purpose of a treaty when:

i. it has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not to become a party to the treaty; or
ii. it has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed.

Thus, it is clear that treaty overrides constitute a violation of international law.

7.2. Treaty Overrides in Nations

Over the last few decades, the number of bilateral tax treaties has increased dramatically. Developing countries are increasingly entering into tax treaties with developed and other developing countries in order to facilitate cross-border trade and investment.

This part evaluates the global perspective concerning matters such as the status of tax treaties with respect to domestic law and the permissibility of tax treaty overrides in various nations, through the study of a chosen few developed and developing countries.

(i) Developed Nations

United States

After exploring alternative means of mitigating the burdens of double taxation, the United States concluded its first bilateral tax treaty in 1932. In nearly seventy years since the conclusion of this treaty, the United States' network of bilateral tax treaties has grown to embrace more than sixty countries, while the U.S. network of estate and gift tax treaties now embraces sixteen countries.

The 1954 Internal Revenue Code (IRC) contained two provisions controlling the tax provisions and national laws i.e. Section 7852 and Section 894(a). These provisions were further modified by Technical and Miscellaneous Revenue Act 1988 (TAMRA) and the impact of these modifications, on the relationship between tax treaty and subsequently enacted tax laws, has been a subject of debate.

Prior to 1988, Section 894(a) of the IRC provided that "income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle". This was later replaced by Section 894 (a)(1) which provides that "The provisions of this title shall be applied to any tax payer with due regard to any treaty obligation of the United States which applies to such tax payer."

At first, the inclusion of term "due regard" did not seem to have effected a radical change between tax treaty and internal revenue code, however, the true impact of its change can only be estimated when Section 894(a)(1) is read along with Section 7852(d), which states "For purposes of determining the relationship between the provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or a law". The congress has hence attempted to codify its own peculiar interpretation of the judicially created "later-in-time rule" upon which its legislative overrides have been based.

This can be further interpreted by inferring the legislative history of Section 7852. Under Section 101212(aa)(2)(C) of the proposed House Bill, any other amendment made by the Reform Act should prevail over conflicting treaty provisions not identified by the mention list in the House Bill. Despite opposition, it was proposed again in the 1988 TAMRA House Bill.

Further the Finance Committee Report of 1988 explains in general:

"The bill modifies the 1954 'transition rule' (embodied in sec. 7852(d)) governing the relationship between treaties and the Code to clarify that it does not prevent application of the general rule providing that the later in time of a statute or a treaty controls sec. 7852(d).

Under the U.S. Constitution, "Laws of the United States which shall be made in pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land." This "Supremacy Clause" was intended to ensure the supremacy of both U.S. federal laws and treaties to state laws, and was one of the major innovations in the Constitution.

As seen above, the congress has opted for its own peculiar interpretation of the principle of lex posterior (later law abrogates a prior contrary law), under which any conflict between a later statute and an earlier treaty would be resolved in favor of the statute without regard of any intention or consideration on the impact on the treaty.

On the other hand, the judiciary has limited and clarified the lex posterior principle by providing that "A treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of congress has been clearly expressed."

This was further affirmed in a case in 1888, Whitney v. Robertson, where the terms of a treaty between the United States and Dominican Republic were in conflict with a subsequent legislation passed by the U.S. government, and where the Court held that, "the duty of the courts is to construe and give effect to the latest expression of the sovereign will." This was also was reaffirmed in a case in 1957, where the court stated "An Act of Congress, which must comply with the Constitution, is on a full parity with a treaty, and … when a statute which is subsequent in time is inconsistent with a treaty, the statute to the extent of conflict renders the treaty null."

In practice, certain legislations passed by the U.S. have been a topic of debate as they may be construed as cases of treaty override, but even if so, a few commentators believe they were justified.

An example of one such legislation was the Branch Profit Tax (BPT), which was enacted in 1986 to equalize the position of foreign investors who operate in the US through a subsidiary and a branch, and under which, withholding tax was levied along with tax on branch income, with limitations to prevent treaty shopping. Many U.S. tax treaties forbade taxing distributions from foreign corporation residents in a treaty country to their foreign shareholders even if distribution came out of earnings of a U.S. branch and arguably the branch profits violated the spirit of this rule. It was thus reasonably considered to be the commission of a treaty override.

Overriding a treaty is violation of doctrine of 'Pact sunt servanda' integrated in the Vienna Convention on Law of Treaties (VCLT). The United States has not ratified the Vienna Convention on the Law of Treaties; nevertheless, those provisions of this convention that constitute the codification of customary international law are binding on the United States. However, a few commentators still believe, that an override may be justified if it is consistent with the underlying purpose of the treaty.

Germany

Under German law, an incorporated treaty is effectively domestic law, but special priority is granted to the incorporated treaty over truly domestic law. Tax treaties prevail over national laws. Even though they have the same stature as the national tax laws. This longstanding principle of German tax law has been followed by the Imperial Tax Court and by the Federal Tax Court since late 1930s.

Today, Article 59 of the German Fiscal Code states "Treaties with other states of the Basic Law take precedence over national tax laws if the treaties have been incorporated properly into applicable national laws". This explains that the German national legislature cannot override income tax treaties through subsequent legislation.

This can be further asserted in a decision published on 12 February 2014, in a case between German Limited Partnership and an Italian resident who owned an interest in KG itself. Here due to the 2009 amendment of the German Income Tax Act pursuant to Section 15(1), interest paid to a partner of a German business partnership is re-characterized as business income and taxed accordingly in the hands of the partner, which consequently denied Italy the right to tax the interest under Article 11 (1) of the Treaty.

In its decision the German Federal Fiscal Court (BFH) stated that this unilateral reclassification of remunerations, which generally falls under a (specialty) article of a treaty, is an override of those provisions and hence commits an unconstitutional breach of international law.

United Kingdom

There is a certain ambiguity surrounding the position of the United Kingdom, with respect to treaty override, as is evidenced by its domestic legislations.

The provisions regarding relief by agreement with other countries that were formerly incorporated under section 788(3) of the ICTA, 1988, are now embodied in section 6 of the Taxation (International and Other Provisions) Act, 2010, which reads as follows:

'Subject to this Part and Part 18 of ICTA, double taxation arrangements have affect in accordance with subsections (2) to (4) despite anything in any enactment.'

These sub-sections deal with double taxation agreements that have effect in relation to income tax, capital gains tax and petroleum revenue tax.

The question that arises is regarding the interpretation of these provisions, which imply that double tax treaty is to be given effect 'notwithstanding anything in any other enactment'. Whether it means that any law extant at the date the treaty comes into effect, or does it mean that no domestic legislation past or future, can constrain the effectiveness of the tax treaty.

A further attempt to clarify U.K.'s position, as regards treaty overrides, can be made by analyzing one of the few alleged instances of a treaty override in the U.K. – the enactment of a section in the Finance Act, 1987, purportedly done by the Government with the purpose of nullifying the effect of the judgment in Padmore's case.

Mr. Padmore was a partner in a Jersey partnership, which consisted of over 100 partners, who were mostly UK resident. Two managing partners who were resident in Jersey carried on the day-to-day business of the partnership. Mr. Padmore claimed that he was entitled to exemption from income tax, in respect of his share of profits, in the U.K. under the U.K.-Jersey Double Taxation Agreement, which provided, in Paragraph 3, for 'the relief from UK tax of the industrial or commercial profits of a Jersey enterprise'.

In the present case, the court judged that since a partnership in Jersey didn't carry on its business through a permanent establishment in the United Kingdom, the United Kingdom Government could not tax Mr. Padmore who is a partner of the partnership as a U.K. resident. The court's decision prompted the Government of the day to promote legislation to remove the exemption exploited by Mr. Padmore.

An analysis of the U.K. government's enactment of section 62 in 1987, in response to the judgment delivered in the first Padmore case, demonstrates that this action was taken by the legislators with the clear intention of overriding, in all probability, both, the interpretation of the U.K.-Jersey tax treaty by the Courts and the terms of the treaty itself.

The action of creating a provision in domestic legislation with the intention, on behalf of the legislator, of having its effects being clearly conflicting with international obligations derived from previously executed treaties, constitutes a treaty override. Thus, it can be concluded that treaty override in the UK is only possible where it is the clear intention of the legislator to achieve it.

Singapore

Singapore's earliest tax treaties were concluded with the United Kingdom and Malaysia in 1966. There are now 38 comprehensive treaties in force.

Section 49 of the Income Tax Act of Singapore states:

'If the Minister by order declares that arrangements specified in the order have been made with the government of any country outside Singapore with a view to affording relief from double taxation in relation to tax under this Act and any tax of a similar character imposed by the laws of that country, and that it is expedient that those arrangements should have effect, the arrangements shall have effect notwithstanding anything in any written law.' Thus, a Singapore tax treaty acquires the force of statutory law.

Though not a signatory to the Vienna Convention on Law of Treaties, Singapore, like other non-signatory states, is obligated to observe it as principles of customary international law and is bound by Article 26 of the VCLT.

But the parliament cannot restrict the future law-making power of its legislators. In case of a further legislation, under Section 49 of Singapore's Income Tax Act, domestic law passed subsequently can operate to restrict the scope of a tax treaty or revoke a part or the whole of the treaty. Presumably, the provisions that are enacted later would prevail; unless they are general and do not override an earlier provision that is special. This can be said in conformity with Section 9A of the Interpretation Acts, which says an interpretation that would promote the purpose or object underlying the written law (whether that purpose or object is expressly stated in the written law or not) shall be preferred to an interpretation that would not promote that purpose or object.

In case of *IRC v. Colco Dealings Ltd.*, it was implied that incase of an override the courts would have to give effect to the domestic provisions if their language is clear, even if they offend the rules of international law.

(ii) Developing Nations

India

In most common law jurisdictions, treaty law has the same status as domestic law and therefore, using the general principle that a later law overrides an earlier law; the treaty override is usually effective. There may, of course, be protection for treaty law built into the domestic legal system – as is the case in India.

The correct legal position in India is that where a specific provision is made in the double taxation avoidance agreement, that provision will prevail over the general provisions contained in the Income Tax Act, 1961. In fact, due to the double taxation avoidance agreements which have been entered into by the Central Government of India, Section 90 of the Income Tax Act, 1961 provides that the laws in force in either country will continue to govern the assessment and taxation of income in the respective countries; except where provisions to the contrary have been made in the agreement.

The Indian judiciary has also played an appreciably large role in affirming this stand taken by India, of assigning tax treaties the power to override contradictory domestic legislation. This has been illustrated through a number of defining judgments of the various Indian High Courts, as well as of the Supreme Court.

In the case of Commissioner of ***Income Tax v. Vishakhapatnam Port Trust, Jagannadha Rao, J.*** stated, "The question of law referred to us at the instance of the Commissioner of Income-tax, Andhra Pradesh, Hyderabad, is whether, on the facts and in the circumstances of the case, the assessee is immune from liability either wholly or partly to tax on the basis of the Double Taxation Avoidance Agreement between Germany and India? We agree with the Tribunal and answer the question referred to us in the affirmative – in favour of the assessee, Port Trust, and against the Department – that the assessee is immune from liability either wholly or partly to income-tax in view of the provisions of the Double Taxation Avoidance Agreement between the Federal Republic of Germany and India."

In the case of ***Arabian Express Line Limited v. Union of India***, the petitioner, M/s. Arabian Express Line Limited, United Kingdom, was a resident of the United Kingdom, who had pleaded that in accordance with Article 9(1) of the Agreement for the Avoidance of Double Taxation between the Government of India and the Government of the United Kingdom, the entire shipping income of the United Kingdom company be exempted from tax in India. The petitioner produced a certificate issued by the Assistant Commissioner of Income-tax, Company Circle, Calcutta, which affirmed that they were so exempted from the tax with effect from April 1, 1992. Despite this and other similar documentary evidence, the Income Tax Officer, Gandhidham, passed an order, which levied taxes and imposed penalties. The Supreme Court held that this order was illegal and contrary to the Circular issued by the Central Board of Direct Taxes and the convention between the Government of India and the United Kingdom.

Both, the Andhra Pradesh High Court and the Supreme Court, through their respective judgments, clearly spelt out that the tax treaty referred to in that particular judgment was conferred with the power to override the relevant domestic legislation or order.

It is thus, well settled that in the event of a conflict between a Double Taxation Agreement and a specific provision contained in the Income Tax Act, the provisions of the Double Taxation Agreement will prevail over the statutory provisions contained in the said Act. However, this unanimous, unflinching view of the Indian courts was in danger of losing its reliability, after the judgment passed by the Bombay High Court in the Vodafone case.

Through the $11.2 billion deal in May 2007, Vodafone International Holdings, a Dutch company, acquired a 67 per cent stake in the Hutchison-Essar Ltd (HEL) from the Hong Kong-based Hutchison Group through CGP (Holdings) Limited (CGP), a Cayman Island Company.

The Income-tax Department took a view that Vodafone was liable to withhold taxes on payments made to the Dutch company since the transaction resulted in transfer of controlling interest of the Indian company. Vodafone filed a writ petition in the Bombay High Court, inter alia, challenging the jurisdiction of the tax authorities in the matter. By its order dated 3 December 2008, the Bombay High Court held that the tax authorities had made out a prima facie case that the transaction was one of transfer of a capital asset situate in India, and accordingly, the Indian income-tax authorities had jurisdiction over the matter.

This decision of the Bombay High Court caused tremors, no matter how slight or for how short a time, in the unwavering stand taken by the Indian courts, as regards the question of whether a domestic legislation could have an overriding importance even if a double tax treaty, specifying the relevant provisions, was in place.

However, on appeal by Vodafone, the Supreme Court set aside the Bombay High Court judgment asking Vodafone International Holding to pay income tax of Rs 11,000 crore on the aforementioned transaction. It was held by the court vide its order dated January 20, 2012, that the transaction was not liable to tax in India as no direct transfer of the shares of Indian company had been made.

But in an alarming development, the Government of India, instead of accepting the Supreme Court verdict, made retrospective amendments in certain provisions of the Income Tax Act, through explanations to those sections provided in the Finance Bill, 2012, to nullify the effect of Vodafone's case.

Section 2(14) of the Income Tax Act was amended so as to clarify 'that "property" includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever.'

Section 2(47) was amended to clarify 'that "transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India'.

Section 9 was amended to clarify that 'an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.'

The net effect of the aforesaid amendments was that the decision of the Supreme Court in Vodafone's case was no longer a good law. Now, any transaction entered into outside India between two foreign residents would also be subject to the provisions of the Indian Income Tax Act if the said transaction had any bearing on any asset situated in India. Though the Government then decided to settle Vodafone's case amicably, this action of the Legislature to amend law retrospectively had a direct negative impact on the foreign investment in India.

Close on the heels of this controversial Vodafone case, were two equally important cases concerning similar matters – the Nokia case and the Sanofi Aventis case.

Nokia, a tax resident of Finland and a leading manufacturer of GSM equipment, had, during the relevant years, Nokia a Liaison Office ("LO") and also a 100% subsidiary in India known as Nokia India Private Limited ("NIPL"). Nokia sold GSM equipment manufactured in Finland to Indian telecom operators outside India on a principal-to-principal basis. Installation activities were undertaken by NIPL under its independent contracts with Indian telecom operators. The LO carried out advertising activities for Nokia.

The main issue before the Delhi High Court was whether consideration for supply of software embedded in the GSM equipment supplied by Nokia can be taxed as royalty in view of the India-Finland tax treaty and the amended provisions of the Finance Act 2012, which expanded the scope of the definition of royalty under the Act to include the use of any right in a computer software.

Adjudicating on the question of whether the payments made for the embedded software were in the nature of royalty, the Court held that since Nokia was a Finnish resident in terms of the India-Finland double taxation avoidance agreement (the DTAA), it was eligible for the benefits accruing to it under the DTAA as provided for under Section 90(2) of the Income Tax Act, which reads as follows:

'Where the Central Government has entered into an agreement with the Government of any country outside India under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.'

The definition of royalty would therefore have to be considered as emanating from the DTAA, which under article 12 of the DTAA provided for a narrower and more restricted meaning of the term royalty.

Further, retrospective amendments made to the definition of royalty under the IT Act had no bearing on transactions taxed under DTAAs.

Sanofi Aventis, a French company had, in 2009, acquired the majority stake of another French company, Mérieux Alliance, in Hyderabad-based vaccine firm Shantha Biotechnics in a deal that valued the company at €550 million (about 3,783 crore). Mérieux Alliance owned 80% in Shantha through its subsidiary ShanH. Sanofi's vaccine division, Sanofi Pasteur, acquired this stake.

In its ruling, the Authority for Advance Ruling (AAR) had held that this offshore share sale transaction between the two French companies, was taxable in India under Article 14(5) of India-France tax treaty.

However, the Andhra Pradesh High Court has ruled that France, not India, is entitled to Rs. 650 crore in capital gains tax arising from the this sale of Hyderabad-based Shantha Biotechnics to a Sanofi Aventis. The court's ruling, clarifies that tax treaties override the controversial retrospective amendments that India made to the income tax law.

Decisions in cases such as the Nokia case, the Sanofi Aventis case and the recently decided case of B4U International Holdings Ltd. vs. DCIT, demonstrate the respect which the Indian judiciary accords to tax treaties with other countries and provide an anchor in otherwise choppy waters created post the Vodafone tax litigation and the frequent Explanations inserted to the relevant sections of the IT Act by the Indian government, which many argue are slowly eroding the principles of source based taxation.

Notwithstanding the Courts' stance, recent legislative developments may give rise to concerns regarding India's standpoint on these issues. The Direct Tax Code Bill, introduced in 2010, incorporates the General Anti-Avoidance Rule, which, in effect, implies that any arrangement entered into by a person may be declared as an impermissible avoidance arrangement by the Commissioner of Income-tax, if it is evident that the main purpose of the arrangement is to obtain a tax benefit.

It was proposed to provide, in the DTC, that between the domestic law and relevant DTAA, the one that is more beneficial to the taxpayer should apply, in keeping with the current provisions of the Income Tax Act. It was also proposed, however, that a DTAA will not have preferential status over the domestic law in the following circumstances:

(i) When the General Anti Avoidance Rule is invoked, or
(ii) When Controlled Foreign Corporation provisions are invoked or
(iii) When Branch Profits Tax is levied.

Any apprehensions raised that the aforesaid proposals would lead to a treaty override, were countered by the reasoning that this 'limited treaty override' would be in accordance with the internationally accepted principles and would not be in conflict with the DTAA's, as anti-avoidance rules are part of the domestic legislation and are not addressed in tax treaties.

The DTC Bill further provided that neither a DTAA nor the Code would have a preferential status by reason of its being a treaty or law; but, in the case of a conflict between the provisions of a treaty and the provisions of the Code, the one that is later in point of time would prevail. As the DTC would be the 'later provision', as regards the bilateral DTAA's that are already in existence, it is clear that the DTC would be vested with overriding authority, in case of the aforementioned conflict. The enactment of the DTC could thus, constitute a treaty override.

Currently, the government plans on coming up with a modified Direct Taxes Code (DTC) Bill after incorporating the suggestions of the Standing Committee on Finance, which has suggested a slew of changes to the legislation.

Mexico

The Mexican Constitution provides, in Article 133, as follows:

'This Constitution, the laws of the Congress of the Union that come from it, and all the treaties that are in accord with it, that have been concluded and that are to be concluded by the President of the Republic with the approval of the Senate will be the Supreme Law of all the Union. The judges of every State will follow this Constitution and these laws and treaties in considering dispositions to the contrary that are contained in the constitutions or the laws of the States.'

In 1999, the Mexican Supreme Court of Justice (Suprema Corte de Justicia de la Nación) determined that international treaties are below the Constitution and above national law (federal, state and municipal).

In a recent resolution, the Mexican Supreme Court of Justice has determined that the international treaties signed by Mexico are in accordance with the Vienna Convention of the Law of Treaties, based on principles of international law, as well as in the internationally customary principle of "pacta sunt servanda", therefore Mexico binds itself to these obligations before the international community and cannot avoid its fulfillment calling on domestic provisions because this would make Mexico liable internationally.

Therefore, in accordance with the Mexican Constitution, Mexico's tax treaties take precedence over domestic law in terms of their application-the text of a treaty prevails in the event of any apparent dispute or inconsistency.

However, in the recent years, there has been an amendment in a domestic legislation, which could be treated as a possible treaty override.

Under Article 210 of the Mexican Income Tax Law (MITL), a non-resident is subject to tax in Mexico if it derives income from a Mexican source or if the non-resident is deemed to have a permanent establishment (PE) in Mexico.

The reform to the MITL, which became effective on January 1, 2005, introduced a modification to Article 210, which indicated that all income subject to taxation in accordance with Title V of the Mexican Income Tax Law (Of Residents Abroad with Income Proceeding from Sources of Wealth Located in National Territory) should not be considered as income for 'entrepreneurial activities'.

The effect of these reforms is that they may cause the tax authorities to construe that certain income, which, prior to the enforcing of the amendment was not subject to the burden in Mexico, for being entrepreneurial benefits, would now be subject to the Mexican Income Tax Law. For instance, specific types of payments made by Mexican residents to non-residents without a permanent establishment (PE) in Mexico might be subject to full Mexican withholding tax at a rate of 25%, even if the recipient is resident in a country that has concluded a tax treaty with Mexico.

In light of these developments, there exists a possibility of a conflict arising between the analysis of Mexico's tax treaties and the current position of the tax authorities.

Africa

The African perspective on treaty override has been exemplified through an analysis of the provisions of tax treaties and domestic legislations of Ghana and Tanzania.

The position of the Ghanaian domestic law vis-a-vis Double Taxation Avoidance Agreements entered into by Ghana with other States, can be illustrated with a hypothetical example.

X, a company incorporated and tax resident in London, is listed on the London Stock Exchange; the majority of its shareholders being corporate investors, who may not necessarily be tax residents of the United Kingdom. Z is a company that is tax resident in Ghana. Z pays royalties to X for the use of certain intellectual properties.

Under Article 12(1) of the U.K.-Ghana Double Taxation Convention, royalties arising in Ghana and paid to the residents of U.K. may be taxed in the U.K.. Article 12(2) further provides that if the royalties are to be taxed in Ghana under the domestic laws, they would not be subject to the Ghanaian withholding tax rate of 25% (for residents) but rather at the rate of 12.5% under the tax treaty.

However, Section 111(4) of Ghana's Internal Revenue Act, 2000 (Act 592), states:

‘Where an international arrangement provides that income accruing in or derived from Ghana or some other amount is exempt from Ghanaian tax or is subject to a reduction in the rate of Ghanaian tax, the benefit of that exemption or reduction is not available to a person who, for the purposes of the arrangement, is a resident of the other contracting state where fifty per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other contracting state for the purposes of the arrangement.’

Section 166 of the same law defines “underlying ownership”

(a) in relation to an entity, means an interest held in or over the entity directly or indirectly through one or more interposed entities by an individual or by an entity not ultimately owned by individuals; or

(b) in relation to an asset owned by an entity, is determined as though the asset is owned by the persons having underlying ownership of the entity in proportion to that ownership of the entity.

Applying the facts of the given situation, it can be interpreted that the payment of royalties may be regarded as an amount exempt from or subject to a reduction in the rate of Ghanaian tax under an international arrangement (which in this context, would refer to the U.K.-Ghana Double Taxation Convention), as provided under Section 111. Further, the definition of underlying ownership under Section 166 suggests that the tax residency of non-individuals (such as the corporate investors referred to in the given example) should also be considered, with the effect that tax treaty relief would be unavailable if more than 50% of the shareholders (whether individuals or not) of X are not tax residents in the U.K.

The fact that X is a listed company, makes it very difficult to prove that more than 50% of its shareholders are U.K. tax residents, since shareholders of London listed companies constantly change, and some shares may be held by nominee shareholders.

The enforcement of Section 111(4) of the Ghana Internal Revenue Act, 2000, consequently makes it very difficult for London listed companies to avail themselves of the benefits conferred by the U.K.-Ghana tax treaty.

Section 128 of the Tanzanian Income Tax Act, 2004 explicitly provides:

‘To the extent that the terms of an international agreement, to which the United Republic of Tanzania is a party, are inconsistent with the provisions of this Act, apart from subsection (5) and Sub-division B of Division II of Part III, the terms of the agreement prevail over the provisions of this Act.’

Sub-section (5) of Section 128 is to be read with sub-section (4), which applies when an international agreement provides that the United Republic of Tanzania shall exempt income or a payment or subject income or a payment to reduced tax.

Sub-section (5) states that this exemption or reduction would not be available to any entity which either is, for the purposes of the agreement, a resident of the other contracting state; and 50 percent or more of whose underlying ownership is held by persons, being individuals or entities who are not, for the purposes of the agreement, residents of the other contracting state or the United Republic of Tanzania.

7.3. Impact of Treaty Overrides

A material breach of a bilateral treaty by one of the parties and the subsequent violation of international law embodied in the Vienna Convention on the Law of Treaties (VCLT) grants the other party the right to terminate the treaty.

This frustration of a treaty is often detrimental to a State in a number of ways.

First, each time it enacts a legislative override, it amounts to violation of international law, which damages the reputation of the State as a member of the international community as well as the international legal order itself.

Second, because treaties are really no more than contracts between sovereign nations, legislative overrides erode the trust of treaty partners undermining that the state will remain faithful to its obligations.

Third, these overrides might itself harm the citizens and residents of the overriding State, who may wish to avail themselves of the benefits of tax treaties, as violation as led an increasing number of treaty partners to insist upon a right to renegotiate or retaliate. This was seen in case of successive U.S. treaty overrides, where the European countries have been joined in their criticism by prominent United States professional organizations.

Treaty overrides, thus, create friction between a State and its treaty partners and may even undermine, to some extent, the comity upon which the network of international tax agreements ultimately rests. The negative consequences of treaty overrides may appear so far to be small, but there is a significant downside risk for the long term.

8. Treaty Shopping

Treaty shopping refers to a "situation where a person who is not entitled to benefits of a tax treaty makes use-in the widest sense of the word of an individual or of a legal person, in order to obtain those treaty benefits that are not available directly."

Treaty shopping is defined as routing of income arising in Source country, to a person in another country (country of residence), through an intermediary country, to obtain an unintended tax advantage, through interpretation of tax treaties between the three countries.

8.1. Treaty Shopping Structure

The following flowchart indicates the structure of Treaty Shopping:

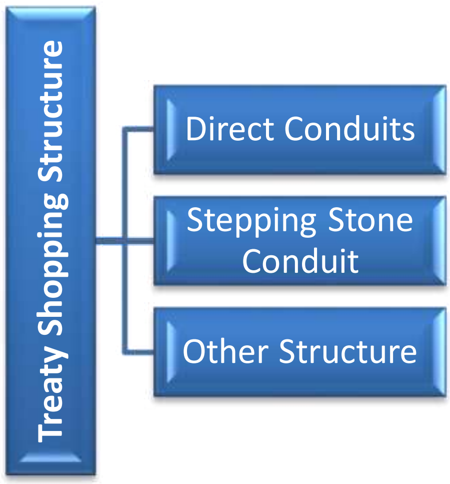

Fig. Structure of Treaty Shopping

(i) Direct Conduits

The word conduit means a channel for conveying water or other fluid. In the context of Treaty shopping, it implies setting up an intermediary company or entity which is used to transfer earnings from Source State to the State of residence in a manner that it reduces overall taxes.

Example: Parent of State of Residence (US Co) expects to derive certain dividends, interest or royalties sourced in another state (State S (India)).

It sets up entity in a third state (State C (Mauritius)) that will receive dividends, interest, and royalties in a more tax beneficial way, than if income were paid directly from State S to R. The benefit arises in such cases because the treaty between the source country (India) and the country of the conduit provides for a lower withholding tax rate, as compared to the treaty between the source country (India) and the country of residence.

(ii) Stepping Stone Conduit

In case of a Stepping stone conduit, a Company which is a resident of State R, establish company resident in State C, where it is fully subject to tax on income derived from Source

State (State S). However, the company in State C, pays high interest, royalties, service fees, commissions etc. to a second related foreign company in a fourth state (State B) and controlled by shareholders of the conduit company (State R). These payments are deductible in State C (resulting in no tax in State C), and are either non taxation or low-rate taxation in State B, due to a preferential regime.

(iii) Other Structures

Following are the other structures involving treaty shopping:

a) Triangular Structures

In such cases, Company in State R (Residence State) sets up a low or nil taxed branch in a Treaty Country. The branch receives income from State of Source that are either not taxed, or taxed at a low rate in the jurisdiction where the branch is situated, due to a favorable Treaty between the State of Source and country of the Branch.

b) Hybrid Entities

Hybrid entities are those entities that are characterized differently in the two Contracting States. For example, in India a partnership is taxed on its income and partners are exempt from distributions by partnership, whereas in some other countries, partnership is considered as transparent entities.

c) Transferring Tax Residence

Individuals can also treaty shop, by transferring tax residence to another treaty country, i.e., ‘emigration’. For example, an individual, who is expecting huge capital gains, and a high tax on such gains in its country of residence, may become a non-resident in that country, immediately before the transfer of capital asset. In such a case, if he is a non-resident, such capital gains may not be taxed in his country of residence. Further, if he becomes a resident of a country which does not have any tax on capital gains, the entire gains would not be liable to tax in any country.

8.2. Main Categories of Anti-Treaty Shopping Measures Currently in Use

Following are the Anti-Treaty Shopping measures currently in use:

(i) Neutral measures, by combining domestic and tax treaty provisions – Beneficial ownership concept in tax treaties.
(ii) Specific measures that deny benefit to entities which are not subject to tax in their state of residence.

(iii) Purpose-based measures that deny certain treaty benefits to entities set up only for claiming such benefits. Example is no tax refunds are given under Netherlands treaty with the U.K.

(iv) Comprehensive measures imposed under domestic legislation or treaties, like, Limitation on Benefits.

9. Limitation of Benefits [LOB] Rule

Double Taxation Avoidance Agreements (DTAAs) were developed to address the problem that arose due to international double taxation. Double taxation occurs when a certain income is taxed in two different countries resulting in the income being taxed twice. These situations generally arise at international level when various countries make a claim to tax the same sum of income. The most common reason for such a situation to arise in an international transaction is due to the coinciding of a specific country's claim to tax the income based on the principle of territoriality with the other country's right to tax the same income based on the resident rule. This results in a situation where the taxpayer is required to pay tax on the same income twice due to a clash between the national laws that exists in different countries.

DTAAs are formulated with the objective of preventing double taxation. These tax treaties are beneficial to the taxpayers as they intend to reduce the tax burden that would have existed without these treaties being in place. But, along with proving advantageous to the taxpayers, these treaties have also provided scope to abuse the existing international tax regime. Individuals and corporations who are not entitled to the benefits under such tax treaties have been observed taking advantages of the treaty arrangements that exists between other countries.

These individuals belonging to the non-treaty country take advantages of such DTAAs by forming a business entity in the country in which the treaty exists for being eligible to take advantage of the tax arrangement that exists in the country and then channel the gain that was made under the treaty back to the country which is not a part of the treaty. The sole purpose of setting up a business entity in the treaty country is to funnel profits from that country to the non-treaty country. This act performed by the individuals and corporations of non-treaty country is called "treaty shopping".

It was imperative to prevent treaty shopping that was being practiced at a large scale by various individuals and corporations as a tool for evading tax liability. With an objective to prevent treaty shopping, a clause was introduced in the treaty that would restrict the benefits derived under the treaty to be availed only be limited number of individuals and entities based on the proximity with the treaty country. This clause in the treaties came to be known as the 'Limitation of Benefit' clause. The purpose of this clause was to exclude conduits and shell entities from availing the benefits under the treaty arrangement by recognizing considerable business nexus between the company and the country in which the treaty operates.

9.1. Indian Model of 'Limitation of Benefit' Clause in Double Taxation Avoidance Agreement

This section will discuss in detail the framework of the 'Limitation of Benefit' clause that exists in various DTAAs in India. It shall begin with laying an overview about the various DTAAs that exist in India along with focusing on the provision of the Income Tax Act, 1961 which empowers the Central government to enter in these DTAAs with different nations. The second part of this section will delve into one specific DTAA which is the India-Mauritius treaty. While discussing this treaty, various Supreme Court judgments will be discussed to lay down the manner in which 'treaty shopping' was considered permissible by the courts. This discussion will finally lead to mapping out the manner in which the 'Limitation of Benefit' clause was introduced in the Indian tax regime through the Supreme Court of India in the case of Azadi Bachao Andolan v Union of India.

9.1.1. Overview of the DTAAs and the Income Tax Act, 1961 in India

The Indian government has entered into almost 90 DTAAs with various countries along with entering into treaty arrangement with various territories such as Cayman Islands, Bermuda, Macau, etc. The government has been empowered to enter into treaty agreement with other countries through the virtue of Section 90 of the Income-tax Act, 1961. This provision grants the government the power to allow various relief on the income which has been taxed twice due to double taxation and also the authority to avoid double taxation of income.

Section 90(2) of the Act further states that in situations where both the Income Tax provision and the DTAA is applicable to the assessees in regarding the avoidance of double taxation, then whichever arrangement is more advantageous to the assessees would apply in that situation. Therefore, reading section 90 of the Income Tax Act, 1963 in its entirety shows that the Central government has not only been authorized to enter into treaties with a foreign government to avoid double taxation but also provides a mechanism through which the DTAAs have to be implemented between India and the other countries.

9.1.2. The India-Mauritius Treaty and Emergence of the 'Limitation of Benefit' Clause in Indian Regime

The reason for focusing on the Indian-Mauritius treaty is based on the large amount of controversy that arose due to it over the years. The reasons behind these controversies were the various aspects of this treaty which allowed double non-taxation along with providing scope for treaty shopping. The double non-taxation was possible in this treaty as it required the capital gains to be taxed only in the country were the assessees resided and not based on the source rule of taxation. This also applied to the capital gains that were received on the sale of the shares of a company.

The application of this arrangement meant that the capital gains which arose from the sale of the shares of an Indian company, would be taxable in the jurisdiction were the assessees resided, which was Mauritius under this treaty. Now, Mauritius being a low-tax jurisdiction does not have any requirement for the capital gain to be taxed. This provided scope for the residents of Mauritius to take advantage of being exempted for paying any tax in the Indian jurisdiction for the capital gain that arose out of the transaction along with not being required to pay any tax on this transaction in Mauritius. This treaty was being used to avail this double non-taxation benefit by the residents of Mauritius.

This treaty was also being used for 'treaty shopping' which had led to a huge controversy. 'Treaty shopping' was being performed by those investors who were planning to invest in India. These investors with an objective to avail the benefit that existed under this treaty became residents in the jurisdiction of Mauritius. They set up shell companies only with the objective of getting an advantage under this treaty and used them to channel the profits that was made through these companies to the non-treaty nations, were these investors resided. This became a serious issue and various controversies arose due to the existence of this arrangement. The Central Government of India tried resolving these controversies by circulating a notification stating that 'treaty shopping' was permissible. This notification just required a proof of residence which the assessees had to obtain from the Mauritian tax authorities in the form of a Tax Residency Certificate.

This notification by the Central government was challenged in the Supreme Court of India in the case of ***Azadi Bachao Andolan v. Union of India***. The court held the validity of these circulars and observed that treaty shopping was permissible under the arrangement which existed between India and Mauritius. It went on to state that if the Indian Executive wanted to prevent any treaty shopping to take place under this DTAA, then it was essential for them to adopt a 'Limitation of Benefit' clause. The insertion of this clause in the treaty would basically restrict the benefit that could be availed under the treaty. Since, the treaty did not have a 'Limitation of Benefit' clause, there was not an express or implied restriction to prevent people from non-treaty countries to claim benefit under this treaty. Therefore, after this decision by the Supreme Court of India, the Indian and the Mauritian government negotiated to insert a 'Limitation of Benefit' clause on 1st April 2017 to the DTAA that existed between both these countries.

The 'Limitation of Benefit' clause that was inserted in the India-Mauritius DTAA:

"ARTICLE 27A – LIMITATION OF BENEFITS"

A resident of a Contracting State shall not be entitled to the benefits of Article 13(3B) of this Convention if its affairs were arranged with the primary purpose to take advantage of the benefits in Article 13(3B) of this Convention.

A shell/conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of Article 13(3B) of this Convention. A shell/conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State.

A resident of a Contracting State is deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian Rs. 1,500,000 or Indian Rs. 2,700,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.

A resident of a Contracting State is deemed not to be a shell/conduit company if:

a) it is listed on a recognized stock exchange of the Contracting State; or
b) its expenditure on operations in that Contracting State is equal to or more than Mauritian Rs. 1,500,000 or Indian Rs. 2,700,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise."

By the insertion of this clause, the benefit that was available under this treaty was denied to the resident of Mauritius or a shell entity which was set up with the sole objective of taking tax benefits that were being provided by the DTAA. The sub-clause (3) of the clause sets out criteria for declaring an entity as a shell company. It stated that a Mauritian company would be deemed as a shell company if its expenditure on its annual operation is less than Mauritian Rs 1,500,000 or Indian Rs. 2,700,000 in the immediately preceding year. And, subclause (4) lists out various criteria based on which a company could claim that they cannot be regarded as shell companies.

The result of the Azadi Bachao Andolan case led to the introduction of 'Limitation of Benefit' clause in the DTAAs that India had with various countries. The countries like the United Kingdom, Singapore, United States ended up renegotiating the DTAA that existed between India and these countries to include the 'Limitation of Benefit' clause.

9.2. Analyzing the 'Limitation of Benefit' Clause that exists in the DTAA between India and Other Countries

9.2.1. India – United Kingdom DTAA

The Indian government and the government of United Kingdom signed a protocol on 26th October, 2013 to amend the DTAA to include a 'Limitation of Benefit' clause in it to prevent any form of treaty shopping.

Article 28C – LIMITATION OF BENEFITS, reads as under:

Benefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain benefits under this Convention.

Whereby reason of this Article a resident of a Contracting State is denied the benefits of this Convention in the other Contracting State, the competent authority of that other Contracting State shall notify the competent authority of the first-mentioned Contracting State.

This clause indicates that the benefits available under this treaty will not be made accessible to any resident of both the countries if the sole objective behind formulating the entity or perform any transaction was merely done to gain benefits that are available under the treaty. But, this clause also provides a safeguard to the assessees from being treated in a prejudicial manner by the authorities by expanding the clause to include sub-clause (2), which states that if a resident from either India or United Kingdom is denied the benefits under this treaty, then the tax authorities of the state were the income is being generated is required to inform the competent tax authorities of the country of the resident that they have been denied the benefit under this treaty.

9.2.2. India - United States DTAA

The DTAA that exists between India and United States is different from the treaties that India has formed with other countries. This treaty is has been formulated based on the structure of the Model United Nations Convention. A protocol was further signed between India and United States to prevent any treaty shopping under the treaty. The 'Limitation of Benefit' clause that was inserted has set out different tests that are to be satisfied before claiming any benefit under this treaty. Generally, the tax that is deductible based on the source rule under the United States is to be deducted at a rate of 30% on the transaction. The 'Limitation of Benefit' clause inserted in this treaty has been stated below.

ARTICLE 24 – LIMITATION OF BENEFITS, reads as follows:

(i) A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:

a) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the United States; and

b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not resident of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or citizens of the United States.

(ii) The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).

(iii) The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means:

a) in the case of United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934;
b) in the case of India, any stock exchange which is recognized by the Central Government under the Securities Contracts Regulation Act, 1956; and
c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

After a careful examination of the clause, that exists in the DTAA between India and United States it can be said that there are three tests which have been laid down under this clause to satisfy the requirement for availing benefit under this treaty. These test have been discussed in detail below.

Test (a): Ownership-Base Erosion Test:

The clause states that it is required for the resident of the contracting state to hold a minimum of 50% of shares in the company which is held by the resident in which the country of the residence of the company or by the citizen of United States. Along with this, it is required that more than 50% of the income generated from the company should not be given out to the residents of the non-treaty country.

Test (b): Active Trade Test:

The active trade test is based on the engagement and the connection of the business activities of the corporation which is trying to avail the benefit under this DTAA. The first requirement for a company, which is a resident of the treaty state, is that it must be engaged in conducting active trade in the residence country. Secondly, the trade activities which are being conducted by the company must be somewhat in relation to the business of the payer in the other country. Thirdly, the income which is received must be in relation to the business activity.

Test (c): Stock Exchange Test:
It is required for the business entity to either be a resident in India or the United States. Also, it is required that the shares of the company are traded on a regular basis in the authorized stock exchange of the country.

9.3. Contrasting the Model of the 'Limitation of Benefit' Clause in India with Other Countries

This part will include a detailed discussion on the model of the 'Limitation of Benefit' clause that exists in five different countries. After all the models have been discussed, a comparison would be provided between the Indian model of the 'Limitation of Benefit' clause and the models that exist in the countries discussed below.

9.3.1. U.S. Model

The first U.S. 'Limitation of Benefit' clause was formulated based on the U.S.-U.K tax treaty which was formulated in 1945. This treaty had a provision stating that there would exist a general 15% tax and 5% special withholding tax to be imposed on dividends. To qualify for the special tax benefit, the assessees would be required to show that they meet the criteria set out under the ownership test as well as the active business test. But, along with this, they had a further condition stating that even if any assessee qualified under these two tests, he/she won't be able to get the special 5% reduction if it is proven that the relationship between the contracting companies in both the jurisdictions was formed only with the objective of securing a benefit under the arrangement of the DTAA. The objective behind such a strict requirement for benefiting from the withholding tax was to make sure that only genuine companies get a benefit under it.

The 'Limitation of Benefit' clause which included almost all modern limitations and was considered as a highly innovative clause was introduced in the U.S.-Germany tax treaty. Under this clause, there were three alternative methods through which an individual or entity could qualify for tax benefits. The first test was the "automatic qualification" test. It listed down five classes which included various individuals, the government of both countries, public listed companies, non-profit entities, and individuals fulfilling the requirement of the ownership test along with the base erosion test, automatically qualified for the treaty benefits.

The second option was the “Active Business Connection Test”. To qualify under this, test the individual or the entity needs to have an active engagement with the trade and commerce of the other nation along with the requirement of the income being generated must be received only for the trade activities that are conducted. The last alternative is a provision of a safety valve; this allows the countries to the treaty to allow treaty benefits to an individual or an entity based on their discretion.

Then there have been various changes and amendments brought to the US Model treaty in 2016 to include various elements to the ‘Limitation of Benefit’ clause to include stricter conditions.

9.3.2. U.K. Model

The U.K. model revolves around the concept of the “main-purpose test” as a means to prevent any form of treaty abuse. Treaty shopping has been present in the U.K. international and domestic law for a long period of time. The ‘Limitation of Benefit’ clauses in the U.K. DTAA mostly focus on the motive of the taxpayer behind performing the financial transactions based on which they are trying to seek a tax benefit under the treaty. The main objective behind this test was to attack the capital gain avoidance schemes that were formulated by entities or individuals through the means of the reorganization of corporations with the sole objective of taking benefit under the treaty. There was also a requirement to prove that there was a bona fide objective behind the commercial transaction that was taking place between the individuals and the entities.

The standard for the determination of the main purpose of any commercial transaction depended upon the size of the tax advantage which was being granted in relation to the specific transaction. The question to be looked into was whether the tax benefit was the main objective for performing the transaction or if it was just an incidental to the commercial transaction that was taking place.

9.3.3. Australian Model

Australia has eight tax treaties that have the ‘Limitation of Relief’ clause included in them. These clauses have been inserted with the objective to place a limitation on the percentage of the tax benefit that would be granted in the source country to the amount of income that has already been paid in the country in which the resident resides. The main objective of this clause is to prevent double non-taxation through the method of connecting the tax benefit that is received based on the treaty in one country to the tax treatment that is performed in the other state. The ‘Limitation of Benefit’ clause has only been included by Australia in their treaty with Japan and the Unites States. The ‘Limitation of Benefit’ clause with the US has been formulated based on the 1996 U.S. Model treaty with only minor changes to the clause. The clause in the DTAA with Japan is a little unique. It contains four kinds of anti-abuse measures in it. These include a U.S. based ‘Limitation of Benefit’ clause, a subject-to-tax clause, then the resident is also required to pass the "main-purpose test "and there also exists an anti-treaty shopping rule in the DTAA.

Australian tax treaties also contain certain specific anti-double taxation rules in them. These are extremely specific and are formulated with the objective of the target of focusing on preferential tax treatment to specific kinds of industries, specific entities, and specific kinds of transactions. The Australian DTAA has specific anti-abuse measures intertwined with each other.

The 'Limitation of Benefit' clause in a DTAA varies based on the tax regime of every country. The DTAA which has been formed by India and countries like the United Kingdom, India, Mauritius, Singapore place their central focus on the purpose behind the formation of the resident entity and the objective behind conducting the transaction. And, the entities and the transactions which are formed with the sole objective of taking benefit under the DTAA are denied making any claim for tax benefit under the DTAA. On the other hand, the DTAA which has been formulated with the United States is a lot more focused on nature and the characteristics of the entities and the individuals who are seeking tax benefit under the treaty.

10. <u>Tax Heavens</u>

A tax haven, or offshore financial center, is any country or jurisdiction that offers minimal tax liability to foreign individuals and businesses. Tax havens do not require businesses to operate out of their country or the individuals to reside in their country to receive tax benefits.

10.1. Criteria for Tax Heavens

In 1998, the Organization for Economic Cooperation and Development (OECD) gave a number of factors to identify tax havens. Some of the most common factors are given below:

(i) No, or nominal, tax on relevant income
(ii) Lack of effective exchange of information
(iii) Lack of transparency
(iv) No substantial activities

10.2. Benefits of Tax Heavens

The benefits of Tax Heavens are:

(i) Tax Haven countries benefit by way of attracting capital to their banks and financial institutions, which can then be used to build a thriving financial sector.
(ii) Individuals or businesses benefit by saving tax, which in tax haven countries may range from zero to low single digits compared to high taxes in their country of citizenship or domicile.

10.3. Top Tax Heavens in the World

Some of the top tax havens in the world have been enlisted below:

- **(i)** **Bermuda** – Declared the world's worst (or best if one is looking to avoid taxation) corporate tax haven in 2016 by Oxfam with a zero percent tax rate and no personal income tax.
- **(ii)** **Netherlands** – Most popular tax haven among the world's Fortune 500. The government uses tax incentives to attract businesses to invest in their country. One such tax incentive costed an estimated 1.2 billion euros in 2016 to the Netherlands.
- **(iii)** **Luxembourg** – It gives benefits such as tax incentives and zero percent withholding taxes.
- **(iv)** **Cayman Islands** – No personal income taxes, no capital gains taxes, no payroll taxes, no corporate taxes, and the country does not withhold taxes on foreign entities.
- **(v)** **Singapore** – Charges reasonable nominal corporate taxes. Reasonable corporate tax rates are provided through tax incentives, lack of withholding taxes, and what appears to be substantial profit shifting.
- **(vi)** **The Channel Islands** – No capital gains taxes, no council taxes, and no value-added taxes.
- **(vii)** **Isle of Man** – No capital gains tax, turnover tax, or capital transfer tax. It also imposes a low income tax, with the highest rates at 20%.
- **(viii)** **Mauritius** – There is low corporate tax rate and no withholding tax.
- **(ix)** **Switzerland** – Full or partial tax exemptions, depending on the bank used.
- **(x)** **Ireland** – Referred to as a tax haven despite officials asserting that it is not. Apple discovered that two of the company's Irish subsidiaries were not classified as tax residents in the United States or Ireland, despite being incorporated in the latter country.

10.4. Top Companies that Benefit from Tax Heavens

- **(i)** **Apple** – The amount booked offshore is $214.9 billion. It uses Ireland as a tax haven. Apple would have owed the U.S. government $65.4 billion in taxes if tax haven benefits were not used.
- **(ii)** **Nike** – It holds $10.7 billion offshore. It uses Bermuda as a tax haven. It would have paid $3.6 billion for taxes if tax haven benefits were not used. This implies Nike pays a mere 1.4% tax rate to foreign governments on those offshore profits, indicating that nearly all of the money is officially held by subsidiaries in tax havens.
- **(iii)** **Goldman Sachs** – It holds $28.6 billion offshore and uses Bermuda as a tax haven.
- **(iv)** Some of the 50 biggest U.S. companies that have stashed approximately $1.6 trillion offshore include Microsoft, IBM, General Electric, Pfizer, Exxon Mobil, Chevron, Walmart. These 50 companies earned over $4.2 trillion in profits globally, but they

used offshore tax havens to lower their effective overall tax rate to just 25.9%, which was well below the U.S. statutory rate of 35% and even lower than the average levels paid in other developed countries.

11. Beneficial Ownership Rule

The principle of beneficial ownership of shares has its origin in Section 90 of the Companies Act, 2013. Section 90 seeks to render that one or more qualified persons may be appointed by the Central Government to investigate and report on beneficial ownership in respect of any shares or class of shares.

The Companies (Significant Beneficial Owner) Rules 2018 ("the SBO Rules") notified, by the Ministry of Corporate Affairs ("MCA") on 13 June 2018, that companies with such ownership must declare their beneficial ownership until 13 September 2018. SBO Rules aim to define the sole beneficial owner of shares in a variety of corporate structures.

A beneficial owner is an individual who gets to enjoy ownership benefits even though the title to some form of the property is in the name of another individual. It also refers to any individual or group of individuals who have the power to vote or control the transaction decisions, either directly or indirectly, with regards to specific security, such as shares belonging to a company.

Beneficial ownership differentiates itself from legal ownership. In most of the cases, the legal, as well as the beneficial owners, are the same. However, there are some situations where the beneficial owner of a property may wish to remain anonymous, legitimate, and sometimes not-so legitimate.

12. Global Intangible Low Tax Income [GILTI] Regime of USA

GILTI is the income earned by foreign affiliates of US companies from intangible assets such as patents, trademarks, and copyrights. The Tax Cuts and Jobs Act impose a new minimum tax on GILTI.

Before the 2017 Tax Cuts and Jobs Act (TCJA), the United States generally taxed its firms and residents on their worldwide income. However, US firms could defer the tax on foreign subsidiaries' active business earnings until those earnings were repatriated to the United States as dividends. After the TCJA, the United States generally exempts earnings from active businesses of US firms' foreign subsidiaries, even if the earnings are repatriated. (The United States still taxes the income from passive investments of foreign subsidiaries.)

But Congress worried that completely exempting US multinationals' foreign earnings might exacerbate the incentive to shift profits to low-tax jurisdictions abroad. So, Congress added a new 10.5 percent minimum tax on global intangible low-taxed income (GILTI) to discourage such profit shifting. GILTI is intended to approximate the income from intangible assets (such as patents, trademarks, and copyrights) held abroad. Congress considered intangible assets highly mobile—and sought to discourage US firms from shifting these assets offshore.

More specifically, a US business must include GILTI in its gross income annually. GILTI is calculated as the total active income earned by a US firm's foreign affiliates that exceeds 10 per cent of the firm's depreciable tangible property. A corporation (but not other businesses) can generally deduct 50 per cent of the GILTI and claim a foreign tax credit for 80 per cent of foreign taxes paid or accrued on GILTI. Thus, if the foreign tax rate is zero, the effective US tax rate on GILTI will be 10.5 per cent (half of the regular 21 per cent corporate rate because of the 50 per cent deduction). If the foreign tax rate is 13.125 per cent or higher, there will be no US tax after the 80 per cent credit for foreign taxes.

For example, suppose a US corporation is the sole shareholder of a foreign corporation with a manufacturing plant in Ireland, which has a 12.5 per cent tax rate. Suppose the plant cost $100 million to construct, and the foreign income is $30 million (after properly allocating expenses). The corporation would calculate GILTI of $20 million (total foreign income minus 10 per cent of $100 million of depreciable assets). The US tax on GILTI would be $2.1 million before credits for foreign taxes (half of the $20 million of GILTI times the 21 per cent corporate tax rate), and the net US tax after credits would be $0.1 million ($2.1 million − $2 million credit for Irish taxes). In practice, the calculations are much more complicated, as US corporations may have multiple operations abroad—and how to properly allocate expenses among them is unclear.

The Global Intangible Low-Taxed Income tax was put in place to counter-act profit shifting to low-tax jurisdictions. This process goes through a calculation of reducing a CFC's total tested income by the net deemed income from tangible assets. The variance can be considered income from a CFC's intangible assets which is included in the shareholder's income.

Global Intangible Low-Tax Income inclusion under the Tax Cuts and Jobs Act is something that every owner of a controlled foreign corporation should be analysing during 2018 in order to make the best tax planning decisions before year-end. Certain corporations may find it beneficial to increase the amount of tangible property in their CFC while others may decide to restructure their CFC all-together. Individual shareholders should pay close attention to their amount of GILTI because making an election to have their CFC income taxed at the corporate level could result in significant tax savings.

13. Indo-Singapore DTAA

The tax treaty provisions apply to tax residents of Singapore and India. However the benefits of the Protocol do not extend to a shell company that claims to be a resident of either of the contracting countries. A shell company is any legal entity falling within the definition of 'resident' with negligible or nil business operations or with no real and continuous business activities carried out in that contracting country. A resident of a contracting country is deemed to be a shell company if its total annual expenditure on operations in that contracting country is less than S$200,000 or Rs. 50,00,000 as the case may be, in the immediately preceding period of 24 months from the date the gains arise.

13.1. Tax Covered by DTAA

(i) In India: Income Tax including any surcharges.
(ii) In Singapore: Income Tax.

13.2.Taxation of Income from Immovable Property

Income derived from the direct use of or letting or any other form of use of immovable property is subject to tax in the country in which the property is located. This includes real-estate income of an enterprise as well as income from immovable property that is used for carrying out professional services. What constitutes immovable property depends upon the law of the country in which the property is situated. Note that ships and aircraft do not constitute immovable property.

13.3.Taxation of Business Profit

Business income or profits of an enterprise are taxable in the country in which the enterprise is resident. However, if the enterprise carries out business in the other contracting country through a permanent establishment situated in that contracting country, then the profits or income derived from that permanent establishment alone will be liable to tax in the other contracting country.

13.4.Taxation of Shipping and Air Transport Income

(i) Profits derived from the operation of ships or aircraft in international traffic by a resident of one contracting country is liable to tax in that country only (i.e country of residence of the operator).
(ii) Shipping and air-transport income includes:
  a) Profits from participation in a pool, a joint business, or an international operating agency engaged in the operation of ships or aircraft.
  b) Interest on funds connected with the operation of ships or aircraft in international traffic.
  c) Profits derived from the transportation by sea or air of passengers, mail, livestock or goods carried on by the owners or lessees or charterers of the ships or aircraft including profits from:
    - The sale of tickets for such transportation on behalf of other enterprises;
    - The incidental lease of ships or aircraft used in such transportation;

- The use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) in connection with such transportation; and
- Any other activity directly connected with such transportation.

13.5.Taxation of Dividend Income

(i) Dividends paid by a company that is a resident of one contracting country to a resident of the other contracting country may be taxed in that other country (i.e recipient's country of residence). However, such dividends may also be taxed in the source country as follows:
   a) 15% of the gross amount of the dividends. Note however, that if the recipient is a company that owns at least 25% of the shares of the company paying the dividends then a reduced tax rate of 10% of the gross amount of the dividends will apply.
   b) Since there is no dividend tax in Singapore, Indian-resident shareholders who derive dividends from a Singapore-resident company or a Malaysian-resident company that has a source of profit in Singapore, are exempt from Singapore tax on the dividend income.

(ii) Note that the above provisions relating to dividend income do not apply if the recipient of the dividend income:
   a) has a permanent establishment in the country in which the company paying the dividend is resident or
   b) performs independent personal services from a fixed base that is situated in the country in which the company paying the dividend is resident, and that the holding giving rise to the dividends is effectively connected with that permanent establishment or fixed base. In such cases, the dividend income will be treated as income of the permanent establishment or as income derived from the performance of personal services and will be taxed accordingly.

(iii) Dividend income refers to income from shares or other corporate rights that is subject to the same taxation treatment as income from shares.

13.6.Taxation of Interest Income

(i) Interest arising in a contracting country and paid to a resident of the other contracting country may be subject to taxation in the recipient country. However, such interest may also be taxed in the source country as follows:
   a) 10% of the gross amount of the interest if such interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution (including an insurance company);
   b) 15% of the gross amount of the interest in all other cases.

(ii) Note that the above provisions relating to interest income do not apply if the recipient of the interest income:

a) has a permanent establishment in the country in which the interest income arises or b) performs independent personal services from a fixed base that is situated in the country in which the interest income arises, and that the indebtedness giving rise to the interest is effectively connected with that permanent establishment or fixed base. In such cases, the interest income will be treated as income of the permanent establishment or as income derived from the performance of personal services and will be taxed accordingly.

(iii) If due to a special relationship that exists between the borrower and lender, the interest paid exceeds an amount which both the parties might have agreed upon in the absence of such a relationship, the above tax rate will apply only to this agreed upon amount and not the excess amount paid.

(iv) Interest income refers to income from government securities; income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; or any other debt-claims whether or not secured by mortgage.

13.7. Taxation of Royalties

(i) Royalty income arising in a contracting country and paid to a resident of the other contracting country may be subject to taxation in the recipient country. However, royalties may also be taxed in the source country at the rate of 10% of the gross amount of the royalties for the use or right to use any copyright of a literary, artistic or scientific work, including films or tapes used for radio or television broadcasting; any patent; trade mark; design or model; plan; secret formula or process; or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right, property or information as well as for the use or right to use any industrial, commercial or scientific equipment. It does not include payments received for sharing technical knowledge, experience, skill, know-how or processes.

(ii) Note that the above provisions relating to royalty income do not apply if the recipient of the royalty income:

a) has a permanent establishment in the country in which the royalty income arises or

b) performs independent personal services from a fixed base that is situated in the country in which the royalty income arises, and that the right, property or contract in respect of which the royalties are paid is effectively connected with that permanent establishment or fixed base. In such cases, the royalty income will be treated as income of the permanent establishment or as income derived from the performance of personal services and will be taxed accordingly.

(iii) If due to a special relationship that exists between the payer and the recipient of the royalties, the amount of royalties paid exceeds an amount which both the parties might have agreed upon in the absence of such a relationship, the above tax rate will apply only to this agreed upon amount and not the excess amount paid.

13.8.Taxation of Technical Services

Fees for technical services arising in a contracting country and paid to a resident of the other contracting country may be subject to taxation in the recipient country. However, technical services fees may also be taxed in the source country at 10% of gross amount of fees. Note that the above provisions relating to technical services fees do not apply if the recipient of the fees:

a) has a permanent establishment in the country in which the fees arises or

b) performs independent personal services from a fixed base that is situated in the country in which the fees arises, and that the right, property or contract in respect of which the fees are paid is effectively connected with that permanent establishment or fixed base. In such cases, the fees will be treated as income of the permanent establishment or as income derived from the performance of personal services and will be taxed accordingly.

If due to a special relationship that exists between the payer and the recipient of the fees, the amount of fees paid exceeds an amount which both the parties might have agreed upon in the absence of such a relationship, the above tax rate will apply only to this agreed upon amount and not the excess amount paid. Fees for technical services include payments made for services of a managerial, technical or consultancy nature.

13.9.Taxation of Directors' Fees

Directors' fees or other similar payments received by the resident of one contracting country in his capacity as a director of a company that is resident in the other contracting country will be taxed in that other contracting country. In other words, directors' fees are liable to taxation in the country in which the company paying the fees is resident.

8.10. Taxation of Professional Services Income

Income derived by the resident of one contracting country in relation to personal or professional services is subject to tax only in that contracting country except under the following circumstances, in which case the income is liable to taxation in the other contracting country as well:

a) If the person regularly performs activities from a fixed base in the other contracting country; in such cases only that portion of income that is attributable to the fixed base is liable to taxation in the other contracting country.
b) If the person stays in the other contracting country for 90 days or more in a given fiscal year; in such cases only that portion of income derived from activities performed in that other contracting country may be taxed in that other contracting country.

Professional services includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.

8.11. Taxation of Employment Income

Salaries, wages and other similar remuneration in respect of employment will be subject to tax in the country in which the employment is exercised. However, the employment income will be subject to tax in the recipient's country of residence and not the contracting country in which the employment is exercised under the following circumstances:

(i) The individual spends 183 days or less in the country in which employment is exercised for a given fiscal year.
(ii) The remuneration is paid by, or on behalf of, an employer who is not a resident of the country in which the employment is exercised.
(iii) The remuneration is not borne by a permanent establishment or a fixed base in the country in which the employment is exercised.
(iv) The remuneration is derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic.

8.12. Taxation of Income Derived by Artists and Sportsmen

Income derived by artistes (i.e. theatre, motion picture, radio or television artiste or a musician) and sportsmen will be taxed in the country in which the activities are performed. However, if the activities are supported wholly or substantially from public funds of the other contracting country and not the country in which the activities are performed then such income will be taxed in that other contracting country.

8.13. Taxation of Government Service Remuneration and Pension

Remuneration and pension paid by the government of one contracting country to any individual for services rendered on behalf of that government is taxable in that contracting country only, except in cases where the individual is a resident and a citizen of the other contracting country. In other words, remuneration and pension paid by the Government of India to any individual for services rendered on behalf of the Indian Government is exempt from Singapore tax, except in cases where the individual is resident in Singapore and is not a citizen of India. Similarly, remuneration and pension paid by the Government of Singapore to any individual for services rendered on behalf of the Singapore Government is exempt from tax in India, except in cases where the individual is resident in India and is not a Singapore citizen.

Note that the above provisions do not apply to income from services rendered in connection with a Government business enterprise (i.e. a trade or business carried on by a Government for purposes of profit).

8.14. Taxation of Non-Government Pension and Annuity

Non-government pension and annuity (i.e. pension and annuity that is not connected to services rendered in the discharge of Governmental functions) is subject to taxation in the recipient's country of residence.

Pension refers to a periodic payment made for past services rendered or compensation for injuries received in the course of performance of services.

Annuity refers to a stated sum payable periodically at stated times during life or during a specified period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

8.15. Taxation of Payments Made to Students and Trainees

Students and business/technical apprentices who are residents of one contracting country and are presently visiting the other contracting country solely for education or training will not be taxed in this other contracting country on:

(i) Payments received from overseas for their maintenance, education, study, research or training.
(ii) Any amount received as a grant, allowance, or award for the purpose of study, research or training.
(iii) Any remuneration not exceeding US$500 per month or its equivalent in local currency in respect of services performed in connection with study, research or training or for the purposes of maintenance.

8.16. Taxation of Payments Made to Teachers and Researchers

Visiting teachers and researchers who are residents of one contracting country and are presently visiting the other contracting country solely for the purpose of teaching or research at an educational institution for a maximum period of up to two years will not be taxed in this other contracting country on any remuneration for such teaching or research. Note that this does not apply to income from research, if such research is undertaken primarily for the private benefit of a specific person.

8.17. Taxation of Profits of Associated Enterprises

Where an enterprise of one contracting country participates directly or indirectly in the management, control or capital of an enterprise of the other contracting country, and conditions are imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, may be included in the profits of that enterprise and taxed accordingly.

8.18. Taxation of Capital Gains

Gains derived by a resident of one contracting country from the alienation of immovable property that is situated in the other contracting country may be taxed in that other country. Gains derived by an enterprise or resident of one contracting country from the alienation of movable property of its permanent establishment or fixed base that is situated in the other contracting country may be taxed in that other contracting country.

Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft are taxable in the recipient's country of residence. Any other gains are taxable in the recipient's country of residence.

Note: Singapore has abolished capital gains tax.

8.19. Double Taxation Relief

- In India: India offers its residents double taxation relief by deduction i.e. domestic tax is applied on the income after deducting Singapore tax suffered.
- In Singapore: Singapore offers its residents tax credit relief for double taxation of income. In other words, Indian tax paid in respect of income from sources within India shall be allowed as a credit against Singapore tax payable in respect of that income.

8.20. Exchange of Information

- The tax authorities of the contracting countries shall exchange tax information as and when necessary.
- The information exchanged will remain confidential and will only be disclosed to persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of the taxes covered by the DTA.
- There will be no disclosure of any trade, business, industrial or professional secret or trade process.

14. <u>Indo-Cyprus DTAA</u>

After some years of tough negotiations, the new Cyprus India Double Taxation Avoidance Agreement (DTAA) has been signed on 18 November 2016. The new Cyprus India DTAA is expected to re-boost trade and investment activities between the two countries.

The new Cyprus India Double Taxation Avoidance Agreement (DTAA) came into force on 1 January 2017 in Cyprus and on 1 April 2017 in India, where the financial year ends on 31 March. The new DTAA replaces the old one from June 1994.

14.1.Exchange of Information

The implementation of the Article 26 of the OECD model Double Taxation Avoidance Agreement is probably the most important amendment, as it ensured the rescindment of Cyprus from India's black list of non-cooperative countries, to which Cyprus had been added on 01/11/2013.

The new Double Taxation Avoidance Agreement between Cyprus and India now provides for the exchange of information and mutual assistance for tax collection.

14.2.The Importance of Substance

As everywhere in the world, India started to challenge aggressive tax planning that is based on profit shifting to companies in jurisdictions with lower taxation, but such companies having no economic activities and no substance. The new Double Taxation Avoidance Agreement between Cyprus and India focuses on the necessity of substance. Furthermore, both India and Cyprus have signed and started to implement the provisions of the BEPS Initiative (Base Erosion and Profit Sharing Initiative).

14.3. Associated nterprises

Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise in the other Contracting State, or a person of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise in the other Contracting State, and conditions of commercial or financial transaction between the two enterprises are differing from those that would be made between independent enterprises (= arm's-length principle), the profits of the enterprise in the other Contracting State may be taxed in the Contracting State). The tax authorities of the other Contracting State may grant a tax credit for such taxes paid in the Contracting State (Article 9 of the new Cyprus India Double Taxation Avoidance Agreement).

Example: When the managers of an Indian company participate directly or indirectly in the management, control or capital of a Cyprus company that is associated with the Indian company, then the profits of the Cyprus company may be taxed in India, and Cyprus may grant a respective tax credit to the Cyprus company.

14.4.Capital Gains Tax

The Article 13 of the new Cyprus India Double Taxation Avoidance Agreement (DTAA) provides for taxation of capital gains as following:

Gains from the alienation of immovable property may be taxed in the State where the immovable property is situated.

Gains from the alienation of shares of company that derives its income mainly from immovable property may be taxed in the country where the immovable property is situated.

Especially interesting is the Paragraph 5 of the Article 13: Gains from the disposal of shares in a company of a Contracting State may be taxed in that State. In other words, when a person resident of India alienates shares in a Cyprus company, the gains from this alienation may be taxed in Cyprus. However, gains from the disposal of securities, including company shares, are not taxable in Cyprus.

The Paragraph 5 of the Article 13 puts Cyprus in the position of an ideal place for holding companies of Indian residents. It furthermore provides substantial advantages for the setup or investment in funds or fund companies in Cyprus, including Alternative Investment Funds (AIF).

14.5.Withholding Tax

The new Cyprus India Double Taxation Avoidance Agreement stipulates that dividends, interest and royalties may be taxed in the Contracting State that receives the income. However, such dividends, interests and royalties may also be taxed in the Contracting State of which the paying company paying is a resident, as per the laws of that State (= Withholding Tax). In cases when the beneficial owner of the amounts is a resident of the Other Contracting state, then the tax so charged is not to exceed 10% of the gross amount of dividends, interests or royalties.

It is important to mention that the Withholding Tax concerns Indian parties only, as Cyprus does not impose Withholding Tax, except on Cyprus sourced royalty payments.

The DTAA between Cyprus and India also provides for the restriction of relief to the arm's length principle for payments of interest and royalties between related enterprises.

The new Cyprus India Double Taxation Avoidance Agreement (DTAA) and the fact that Cyprus has been rescinded from India's black list provide a strong regulatory basis for Indian companies and investors to benefit from the jurisdiction Cyprus in context with their global tax planning and structuring of investments.

The new DTAA between Cyprus and India provides also an excellent framework to use Cyprus companies as a gateway to the markets of the EU.

Test Your Knowledge

QUESTIONS	
1.	Identify the Treaty Structure from the following statement: a) X Ltd. sets up a branch in low or nil taxed country. Such branch is earning income in such low taxed country which is either taxed on a low rate or not taxed at all. b) Mr. A wants to sell a capital asset but tax on such capital asset is very high on his residence country. Therefore, he transferred his resident ship from a highly taxed jurisdiction to a low taxed jurisdiction just before the transfer of the asset. c) S Ltd. is about to receive dividend from Q Ltd. In order to avoid tax on such dividend, it opens a company Z Ltd. in Mauritius where such income is taxed on a low rate.
2.	Explain the Limitation of Benefits Rule.
3.	Discuss LOB Clause inserted in India-Mauritius DTAA.
4.	How do Governments of various countries earn money from Tax Heavens?

SOLUTIONS	
1.	a) It is a triangular structure as in this structure, company in State R (Residence State) sets up a low or nil taxed branches in a Treaty Country. The branch receives income from State of Source that are either not taxed, or taxed at a low rate in the jurisdiction where the branch is situated, due to a favorable Treaty between the State of Source and country of the Branch. b) It is a case of Transferring Tax Residence and in such structure, individuals can also treaty shop, by transferring tax residence to another treaty country, i.e., 'emigration'. c) It is a case of Direct Conduits. In the context of Treaty shopping, it implies setting up an intermediary company or entity which is used to transfer earnings from Source State to the State of residence in a manner that it reduces overall taxes.
2.	Double Taxation Avoidance Agreements (DTAAs) were developed to address the problem that arose due to international double taxation. Double taxation occurs when a certain income is taxed in two different countries resulting in the income being taxed twice. These situations generally arise at international level when various countries make a claim to tax the same sum of income. The most common reason for such a situation to arise in an international transaction is due to the coinciding of a specific country's claim to tax the income based on the principle of territoriality with the other country's right to tax the same income based on the resident rule. This results in a situation where the taxpayer is required to pay tax on the same income twice due to a clash between the national laws that exists in different countries. DTAAs are formulated with the objective of preventing double taxation. These tax treaties are beneficial to the taxpayers as they intend to reduce the tax burden that would have existed without these treaties being in place. But, along with proving advantageous to the taxpayers, these treaties have also provided scope to abuse the existing international tax regime. Individuals and corporations who are not entitled to the benefits under such tax treaties have been observed taking advantages of the treaty arrangements that exists between other countries. These individuals belonging to the non-treaty country take advantages of such DTAAs by forming a business entity in the country in which the treaty exists for being eligible to take advantage of the tax arrangement that exists in the country and then channel the gain that was made under the treaty back to the country which is not a part of the treaty. The sole purpose of setting up a business entity in the treaty country is to funnel profits from that country to the non-treaty country. This act performed by the individuals and corporations of non-treaty country is called "treaty shopping".

	It was imperative to prevent treaty shopping that was being practiced at a large scale by various individuals and corporations as a tool for evading tax liability. With an objective to prevent treaty shopping, a clause was introduced in the treaty that would restrict the benefits derived under the treaty to be availed only be limited number of individuals and entities based on the proximity with the treaty country. This clause in the treaties came to be known as the 'Limitation of Benefit' clause. The purpose of this clause was to exclude conduits and shell entities from availing the benefits under the treaty arrangement by recognizing considerable business nexus between the company and the country in which the treaty operates.
3.	**"ARTICLE 27A – LIMITATION OF BENEFITS"** A resident of a Contracting State shall not be entitled to the benefits of Article 13(3B) of this Convention if its affairs were arranged with the primary purpose to take advantage of the benefits in Article 13(3B) of this Convention. A shell/conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of Article 13(3B) of this Convention. A shell/conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. A resident of a Contracting State is deemed to be a shell/conduit company if its expenditure on operations in that Contracting State is less than Mauritian Rs. 1,500,000 or Indian Rs. 2,700,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise. A resident of a Contracting State is deemed not to be a shell/conduit company if: (a) it is listed on a recognized stock exchange of the Contracting State; or (b) its expenditure on operations in that Contracting State is equal to or more than Mauritian Rs. 1,500,000 or Indian Rs. 2,700,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise. By the insertion of this clause, the benefit that was available under this treaty was denied to the resident of Mauritius or a shell entity which was set up with the sole objective of taking tax benefits that were being provided by the DTAA. The sub-clause (3) of the clause sets out criteria for declaring an entity as a shell company. It stated that a Mauritian company would be deemed as a shell company if its expenditure on its annual operation is less than Mauritian Rs 1,500,000 or Indian Rs. 2,700,000 in the immediately preceding year. And, subclause (4) lists out various

	criteria based on which a company could claim that they cannot be regarded as shell companies. The result of the Azadi Bachao Andolan case led to the introduction of 'Limitation of Benefit' clause in the DTAAs that India had with various countries. The countries like the United Kingdom, Singapore, United States ended up renegotiating the DTAA that existed between India and these countries to include the 'Limitation of Benefit' clause.
4.	Tax havens are not completely tax-free. They charge a lower tax rate than other countries. Low tax jurisdictions generally charge high customs or import duties to cover the losses in tax revenues. Tax havens may charge a fee for new registration of companies and renewal charges to be paid every year. Additional fees may also be charged such as license fees. Such fees and charges would add up to a recurring fixed income for the tax havens. By attracting foreign individuals or businesses, even if they are only charged a nominal tax rate, the country may earn substantially more in tax revenues than it would otherwise. Also, the country may benefit from corporate investments in business operations that offer jobs to the country's residents.

Module III – Tracking Tax Avoidance with Withholding Taxes

Sr. No.	Contents		
1.	Introduction		
2.	Normative Aspects of Withholding		
	2.1.	Wage Withholding	
	2.2.	Other Domestic Withholding	
3.	Issues and Controversies on Withholding Tax on Foreign Payments in India (Sec. 192, 195, 197, 194C, 194J)		
	3.1.	Salary [Section 192]	
		3.1.1.	Manner of Deduction of Tax
		3.1.2.	Furnishing of Statement of Particulars of Perquisites or Profits in Lieu of Salary by Employer to Employee
		3.1.3.	Circular issued by CBDT
		3.1.4.	Requirement to obtain Evidence/ Proof/ Particulars of Claims from the Employee by the Employer
	3.2.	Section 194 [Payment to Contractors and Sub-Contractors]	
		3.2.1.	Time of Deduction
		3.2.2.	Rate of TDS
		3.2.3.	Threshold Limit for Deduction
		3.2.4.	Definition of Work
	3.3.	Section 194 J [Fees for Professional or Technical Services]	
		3.3.1.	Time of Deduction
		3.3.2.	Threshold Limit for Section 194 J
		3.3.3.	Non-applicability
	3.4.	Section 195 [Any Other Sums Payable to Non-Residents]	
		3.4.1.	Time of Deduction
		3.4.2.	Payment Subject to Tax Deduction
		3.4.3.	Certificate of Non-deduction of Tax at Source
		3.4.4.	Specified class or classes of persons, making payment to the Non-resident, to mandatorily make application to Assessing Officer to determine the appropriate proportion of sum chargeable to tax

		3.4.5.	Procedure for Refund of TDS under section 195 to the person deducting tax in cases where tax is deducted at a higher rate prescribed in the DTAA
	3.5.	Section 197 [Certificate for Deduction of Tax at a Lower Rate]	

15. Introduction

Wars, inter alia, have always been the most important occasions for the introduction of new forms of taxation. At the outset of a war, the state suddenly needs greatly increased revenues to pay for personnel and material to prosecute the war. Although governments typically increase the rates of existing explicit taxes and raise the rate of the hidden “inflation tax” by abruptly augmenting the money stock, these measures often prove insufficient, and other means must be devised to extract resources from the public quickly. One way to capture more revenue is to reduce tax evasion by seizing the people’s earnings before the earners ever lay hands on them. This procedure has come to be known as tax withholding at the source, or simply withholding.

Precedents for withholding U.S. taxes go back as far as the War Between the States, when the Treasury withheld taxes owed by federal employees under the income-tax law adopted in 1862 until an 1864 amendment exempted federal salaries from taxation. The war-spawned income-tax law was repealed in 1872, and an income-tax law enacted in 1894 was quickly declared unconstitutional (but not because it taxed wages and salaries). Immediately after ratification of the Sixteenth Amendment and passage of income-tax legislation in 1913, taxes were withheld at the source. This system provoked so much complaint from employers, however, that even the secretary of the treasury, William Gibbs McAdoo, recommended its elimination, and in 1917 Congress withdrew its authorization. After passage of the Social Security Act in 1935, the payroll taxes it authorized were collected at the source, but income taxes still were not.

Before World War II, individuals who owed federal tax on their income earned in a particular year paid the tax during the following year in quarterly installments. In those days, relatively few people paid income taxes. As late as 1939, fewer than four million individual returns were filed, and the filers’ total tax bill came to less than $1 billion, or less than 4 percent of their net taxable income. When so few people paid income tax and the amounts due in most cases were so small, the system of deferred payment imposed no great burden and gave rise to few taxpayer complaints.

Beginning in 1940, however, the tax burden increased enormously. As the government began to mobilize for participation in a gigantic global war, its revenue demands grew apace. Federal spending burgeoned from $9 billion in fiscal year 1940 to more than $98 billion in fiscal year 1945. Although the greater part of this spending upsurge was financed by borrowing, huge increases in tax collections also took place. In 1945, 50 million individual income-tax returns were filed, and the filers owed more than $19 billion, or almost 20 times the amount that Americans had coughed up for this tax just five years earlier.

Milton Friedman was an economist at the Treasury during the early part of the war. In his 1998 memoirs, Two Lucky People, written with his wife Rose, he observed: “It was clear to all of us at the Treasury, as we set out to multiply the amount of revenue to be collected from the personal income tax, that it would be impossible to do so unless we could develop a system to collect the taxes as the income was earned, not a year later."

The main problem connected with switching to a "pay-as-you-go" system was that when the switch was made, the taxpayers would have to pay two years' taxes in a single year—the amount due under the old system on the previous year's earnings and the amount due under the new system on the current year's earnings. Apart from the vociferous complaints such double-taxation was sure to produce, many people would simply be unable to make all the payments, especially when tax obligations were being increased drastically.

The transition problem sparked a great deal of debate in the government and among the public. Perhaps the leading proposal in 1942 came from Beardsley Ruml, the treasurer of R. H. Macy & Co., who was also the chairman of the Federal Reserve Bank of New York. Ruml proposed to "forgive" the previous year's tax liability completely when the switch to the pay-as-you-go system was made. The Treasury objected to allowing such a great amount of "forgiveness" and proposed an alternative, less-forgiving design.

After more than a year of wrangling in the bureaucracy and in Congress, the Current Tax Payment Act was signed into law on June 9, 1943. It provided for a complicated partial-forgiveness transition. As Friedman described it, the law basically "canceled . . . one year's tax obligations of $50 or less and 75 percent of the required tax on the lower of 1942 or 1943 income, requiring the remaining 25 percent to be paid in two equal annual installments." After the system became fully operational, employers withheld almost $8 billion for income taxes in 1944 and more than $10 billion in 1945.

Charlotte Twight, in a revealing chapter of her 2002 book, Dependent on D.C., shows that during the extended debate that preceded passage of the withholding law in 1943, its proponents used various tactics to misrepresent its workings, its consequences, and the government's reasons for seeking it. In particular, she documents that "the tax 'cancellation' was a sham and was understood to be a sham by a significant number of government officials involved in its passage."

The withholding system has remained in effect continuously ever since 1943, even though the war that prompted its creation ended 62 years ago, and the system's perpetuation has contributed greatly to nourishing the postwar Leviathan state. As Twight says, "Withholding is the paramount administrative mechanism that since 1943 has enabled the federal government to collect, without significant protest, sufficient private resources to fund a vastly expanded welfare state."

Three key types of withholding tax are imposed at various levels in the United States:

a) Wage withholding taxes,
b) Withholding tax on payments to foreign persons, and

c) Backup withholding on dividends and interest.

The amount of tax withheld is based on the amount of payment subject to tax. Withholding of tax on wages includes income tax, social security and medicare, and a few taxes in some states. Certain minimum amounts of wage income are not subject to income tax withholding. Wage withholding is based on wages actually paid and employee declarations on federal and state Forms W-4. Social Security tax withholding terminates when payments from one employer exceed the maximum wage base during the year.

16. Normative Aspects of Withholding

Tax withholding, also known as tax retention, Pay-as-You-Go or Pay-as-You-Earn, is income tax paid to the government by the payer of the income rather than by the recipient of the income. The tax is thus withheld or deducted from the income due to the recipient. In most jurisdictions, tax withholding applies to employment income. Many jurisdictions also require withholding taxes on payments of interest or dividends. In most jurisdictions, there are additional taxes withholding obligations if the recipient of the income is resident in a different jurisdiction, and in those circumstances withholding tax sometimes applies to royalties, rent or even the sale of real estate. Governments use tax withholding as a means to combat tax evasion, and sometimes impose additional tax withholding requirements if the recipient has been delinquent in filing tax returns or in industries where tax evasion is perceived to be common.

Typically the withheld tax is treated as a payment on account of the recipient's final tax liability, when the withholding is made in advance. It may be refunded if it is determined, when a tax return is filed, that the recipient's tax liability is less than the tax withheld, or additional tax may be due if it is determined that the recipient's tax liability is more than the tax withheld. In some cases, the withheld tax is treated as discharging the recipient's tax liability, and no tax return or additional tax is required. Such withholding is known as final withholding.

The amount of tax withheld on income payments other than employment income is usually a fixed percentage. In the case of employment income, the amount of withheld tax is often based on an estimate of the employee's final tax liability, determined either by the employee or by the government.

Most countries require payers of interest, dividends and royalties to non-resident payees (generally, if a non-domestic postal address is in the payers records) withhold from such payment an amount at a specific rate. Payments of rent may also be subject to withholding tax or may be taxed as business income. The amounts may vary by type of income. A few jurisdictions treat fees paid for technical consulting services as royalties subject to withholding of tax. Income tax treaties may reduce the amount of tax for particular types of income paid from one country to residents of the other country.

Some countries require withholding by the purchaser of real property. The U.S. imposes a 15% withholding tax on the amount realized in connection with the sale of a U.S. real property interest unless advance IRS approval is obtained for a lower rate. Canada imposes similar rules for 25% withholding, and withholding on sale of business real property is 50% of the price, but may be reduced on application.

The European Union has issued directives prohibiting taxation on companies by one member state of dividends from subsidiaries in other member state, except in some cases, interest on debt obligations, or royalties received by a resident of another member nation.

Procedures vary for obtaining reduced withholding tax under income tax treaties. Procedures for recovery of excess amounts withheld vary by jurisdiction. In some, recovery is made by filing a tax return for the year in which the income was received. Time limits for recovery vary greatly. Taxes withheld may be eligible for a foreign tax credit in the payee's home country.

16.1. Wage Withholding

Most developed countries operate a wage withholding tax system. In some countries, subnational governments require wage withholding so that both national and subnational taxes may be withheld. In the U.S., Canada, and others, the federal and most state or provincial governments, as well as some local governments, require such withholding for income taxes on payments by employers to employees. Income tax for the individual for the year is generally determined upon filing a tax return after the end of the year.

The amount withheld and paid by the employer to the government is applied as a prepayment of income taxes and is refundable if it exceeds the income tax liability determined on filing the tax return. In such systems, the employee generally must make a representation to the employer regarding factors that would influence the amount withheld. Generally, the tax authorities publish guidelines for employers to use in determining the amount of income tax to withhold from wages.

The United Kingdom and certain other jurisdictions operate a withholding tax system known as pay-as-you-earn (PAYE), although the term "withholding tax" is not commonly used in the UK. Unlike many other withholding tax systems, PAYE systems generally aim to collect all of an employee's tax liability through the withholding tax system, making an end of year tax return redundant. However, taxpayers with more complicated tax affairs must file tax returns.

Australia operates a pay-as-you-go (PAYG) system, which is similar to PAYE. The system applies only at the federal level, as the individual states do not collect income taxes.

16.2. Other Domestic Withholding

Some systems require that income taxes be withheld from certain payments other than wages made to domestic persons. Ireland requires withholding of tax on payments of interest on deposits by banks and building societies to individuals. The U.S. requires payers of dividends, interest, and other "reportable payments" to individuals to withhold tax on such payments in certain circumstances. Australia requires payers of interest, dividends and other payments to withhold an amount when the payee does not provide a tax file number or Australian Business Number to the payer. India enforces withholding tax also on payments between companies and not just from companies to individuals, under the Tax Deducted at Source (TDS) system. (Since April 2016, the United Kingdom has discontinued withholding tax on interest and dividends, though in some cases this income will become liable for taxation through other means). Rwanda charges withholding tax on business payments unless the paying company obtains proof that the recipient is registered with the tax administration and that they have a recent income tax declaration.

17. Issues and Controversies on Withholding Tax on Foreign Payments in India (Sec. 192, 195, 197, 194C, 194J)

Withholding tax is one of the most significant sources of collecting Income Tax under the Indian Income Tax regime. Under the Income Tax Act, 1961 (the Act), responsibility is cast upon the payer to withhold tax on various domestic as well as foreign payments at the source. Over the years, these provisions have assumed great significance and it has shored-up the tax collections of the Indian government.

However, interpretational issues and different views between the taxpayer and the tax authorities in some of these provisions have raked up substantial litigation, especially in the last few years.

The withholding tax requirement in the case of foreign payments arises on the 'sum chargeable to tax'. Thus, the income element in the payments is a pre-requisite for taxes to be withheld.

However, there are instances where taxpayers make reimbursements to their related concern for the payment made by them to a third party on the taxpayer's behalf.

On this issue, the Mumbai Tribunal decision in the case of C. U. Inspections has held that payment to a third party, routed through a related concern, would not be considered as a reimbursement. It held that if the contention of the assessee is accepted, then the relevant provisions of the Act can be circumvented by simply following the modus-operandi to make the payment to the third party, not directly, but through an intermediary to make it appear as a reimbursement of the cost to the intermediary.

This ruling pronounced by the Mumbai Tribunal provides more clarity on reimbursement payments carried on within group companies. Indian entities effecting remittances to foreign related concerns should clearly analyse the nature of the remittance in the context of the ultimate beneficiaries/service providers before remitting it as a reimbursement. Needless to say, the importance of documentation cannot be undermined in strengthening the case for not withholding tax on reimbursements.

Another related issue with respect to reimbursement is the reimbursement of salaries of foreign employees deputed in an Indian company. Whether such reimbursement would attract withholding tax as 'fees for technical services' or the same can be construed as pure reimbursement not requiring any withholding is a contentious issue which involves substantial litigation.

Form 26AS is the summary statement of the gross income and the corresponding tax withheld by various parties on the taxpayer's account in a particular year.

However, as per Section 199 of the Act read with Rule 37BA of the Income Tax Rules, credit for withholding tax should be claimed in the year in which income is offered to tax.

It is possible that the other party has accrued the expense and withheld the tax in either the prior or the subsequent year and, as such, the income shown in Form 26AS may not be offered in the same year. To that extent, there could be inter-year differences in income and withholding tax credit claim.

At the time of assessment, the tax officer verifies whether the income reflected in Form 26AS is offered to tax in the same year. In the case of a mismatch, a general tendency of the tax department is to add the notional income to the taxable income of the taxpayer. Furthermore, due to mismatches in withholding tax credits, even the said credit may not be granted. The onus is on the taxpayer to reconcile the differences which may (sometimes due to factors such as high volume, error by the other party in withholding tax statement, etc.), become a very tedious task. For the irreconcilable items, there is a possibility that not only the credit may be denied, but also the gross amount would be added to the taxable income resulting in a dual hit.

17.1. Salary [Section 192]

This section casts an obligation on every person responsible for paying any income chargeable to tax under the head ‘Salaries’ to deduct income-tax on the amount payable.

3.1.1. Manner of Deduction of Tax

(i) Such income-tax has to be calculated at the average rate of income-tax computed on the basis of the rates in force for the relevant financial year in which the payment is made, on the estimated total income of the assessee. Therefore, the liability to deduct tax at source in the case of salaries arises only at the time of payment.

However, in case an employee intends to opt for concessional rate of tax under section 115BAC and he intimates to the deductor, being his employer, of such intention, then, the employer shall compute his total income, and deduct tax thereon in accordance with the provisions of section 115BAC. If such intimation is not made by the employee, the employer shall deduct tax at source without considering the provision of section 115BAC of the Act.

(ii) Average rate of income-tax means the rate arrived at by dividing the amount of income-tax calculated on the total income, by such total income.

(iii) The concept of payment of tax on non-monetary perquisites has been provided in sections 192(1A) and (1B). These sections provide that the employer may pay this tax, at his option, in lieu of deduction of tax at source from salary payable to the employee. Such tax will have to be worked out at the average rate applicable to aggregate salary income of the employee and payment of tax will have to be made every month along with tax deducted at source on monetary payment of salary, allowances etc.

(iv) An employer, being an eligible start up referred to in section 80-IAC, responsible for paying any income to the assessee by way of perquisite being any specified security or sweat equity shares allotted or transferred, directly or indirectly, free of cost or at concessional rate to the assessee, has to deduct or pay, as the case may be, tax on the value of such perquisite provided to its employee within 14 days from the earliest of the following dates -

a) after the expiry of 48 months from the end of the relevant assessment year; or
b) from the date of the sale of such specified security or sweat equity share by the assessee; or
c) from the date of the assessee ceasing to be the employee of the employer who allotted such shares

Such tax has to deducted or paid on the basis of rates in force for the financial year in which the said specified security or sweat equity share is allotted or transferred.

(v) In cases where an assessee is simultaneously employed under more than one employer or the assessee takes up a job with another employer during the financial year after his resignation or retirement from the services of the former employer, he may furnish the details of the income under the head "Salaries" due or received by him from the other employer, the tax deducted therefrom and such other particulars to his current employer. Thereupon, the subsequent employer should take such information into consideration and then deduct the tax remaining payable in respect of the employee's remuneration from both the employers put together for the relevant financial year.

(vi) For purposes of deduction of tax out of salaries payable in a foreign currency, the value of salaries in terms of rupees should be calculated at the prescribed rate of exchange as specified in Rule 26 of the Income-tax Rules, 1962.

(vii) In respect of salary payments to employees of Government or to employees of companies, co-operative societies, local authorities, universities, institutions, associations or bodies, deduction of tax at source should be made after allowing relief under section 89(1), where eligible.

(viii) A tax payer having salary income in addition to other income chargeable to tax for that financial year, may send to the employer, the following particulars of:

a) such other income and particulars of any tax deducted under any other provision;
b) loss, if any, under the head 'Income from house property'.

The employer shall take the above particulars into account while calculating tax deductible at source.

(ix) It is also provided that except in cases where loss from house property has been adjusted against salary income, the tax deductible from salary should not be reduced as a consequence of making the above adjustments.

3.1.2. Furnishing of Statement of Particulars of Perquisites or Profits in lieu of Salary by Employer to Employee

Section 192(2C) provides that the employer shall furnish to the employee, a statement in Form No. 12BA giving correct and complete particulars of perquisites or profits in lieu of salary provided to him and the value thereof. The statement shall be in the prescribed form and manner. This requirement is applicable only where the salary paid/payable to an employee exceeds Rs. 1,50,000. For other employees, the particulars of perquisites/profits in lieu of salary shall be given in Form 16 itself.

3.1.3. Circular issued by CBDT

Every year, the CBDT issues a circular giving details and direction to all employers for the purpose of deduction of tax from salaries payable to the employees during the relevant financial year. These instructions should be followed.

3.1.4. Requirement to obtain Evidence/ Proof/ Particulars of Claims from the Employee by the Employer

Section 192(2D) casts responsibility on the person responsible for paying any income chargeable under the head "Salaries" to obtain from the assessee, the evidence or proof or particulars of prescribed claims (including claim for set-off of loss) under the provisions of the Act in the prescribed form and manner, for the purposes of –

a) estimating income of the assessee; or
b) computing tax deductible under section 192(1).

Section 192(1) requires any person responsible for paying any income chargeable under the head "Salaries" to deduct tax at source at the time of payment. If an employee receives income chargeable under a head other than "Salaries", section 192 does not get attracted at all.

In the case of ITC Ltd v. CIT (2016) 384 ITR 14, the issue under consideration before the Supreme Court was whether "tips" received by the hotel-company from its customers and distributed to the employees fell within the meaning of "Salaries" to attract tax deduction at source under section 192.

The Supreme Court observed that in respect of tips collected by the company from the customers and distributed to the employees, the person responsible for paying the employee was not the employer at all, but a third person, namely the customer. As income from tips would be chargeable in the hands of the employees as "Income from Other Sources", on account of such tips being received from customers and not from the employer, section 192 would not get attracted at all.

The Supreme Court further observed that there was no vested right in the employee to claim any amount of tip from his employer. Tips are purely voluntary amounts that may or may not be paid by customers for services rendered to them, and hence, would not fall within the meaning and scope of section 15. Further, the amount of tips collected from the customers by the employer and paid to the employees has no reference to the contract of employment at all. Tips were received by the employer in a fiduciary capacity as trustee for payments that were received from customers which they disbursed to their employees for service rendered to the customer. There was, therefore, no reference to the contract of employment when these amounts were paid by the employer to the employee. Due to this reason the tips received by the employees could not be regarded as profits in lieu of salary in terms of section 17(3). The payments of collected tips included and paid by way of a credit card by a customer, would not be payments made "by or on behalf of" an employer. The contract of employment not being the proximate cause for the receipt of tips by the employee from a customer, such payments would be outside the scope of sections 15 and 17.

17.2.Section 194 [Payment to Contractors and Sub-Contractors]

Section 194C provides for deduction of tax at source from the payment made to resident contractors and sub-contractors.

17.2.1. Time of Deduction

Tax has to be deducted at the time of payment of such sum or at the time of credit of such sum to the account of the contractor, whichever is earlier.

Where any such sum is credited to any account in the books of account of the person liable to pay such income, such crediting is deemed to be credit of such income to the account of the payee and the tax has to be deducted at source. The account to which such sum is credited may be called "Suspense account" or by any other name.

However, no tax has to be deducted at source in respect of payments made by individuals/ HUF to a contractor exclusively for personal purposes.

17.2.2. Rate of TDS

The rate of TDS under section 194C on payments to contractors would be 1%, where the payee is an individual or HUF and 2% in respect of other payees. The same rates of TDS would apply for both contractors and sub-contractors.

17.2.3. Threshold Limit for Deduction

No deduction will be required to be made if the consideration for the contract does not exceed Rs. 30,000. However, to prevent the practice of composite contracts being split up into contracts valued at less than Rs. 30,000 to avoid tax deduction, it has been provided that tax will be required to be deducted at source where the amount credited or paid or likely to be credited or paid to a contractor or sub-contractor exceeds Rs. 30,000 in a single payment or Rs. 1,00,000 in the aggregate during a financial year.

Therefore, even if a single payment to a contractor does not exceed Rs. 30,000, TDS provisions under section 194C would be attracted where the aggregate of the amounts of such sums credited or paid or likely to be credited or paid to the contractor during the financial year exceeds Rs. 1,00,000.

17.2.4. Definition of Work

Work includes –
(a) advertising;

(b) broadcasting and telecasting including production of programmes for such broadcasting or telecasting;
(c) carriage of goods or passengers by any mode of transport other than by railways;
(d) catering;
(e) manufacturing or supplying a product according to the requirement or specification of a customer by using material purchased from such customer or its associate, being a person related to the customer in such manner as defined u/s 40A(2)(b) (i.e., the customer would be in the place of assessee; and the associate would be the related person(s) mentioned in that section).

However, "work" shall not include manufacturing or supplying a product according to the requirement or specification of a customer by using raw material purchased from a person, other than such customer or associate of such customer, as such a contract is a contract for 'sale'. However, this will not be applicable to a contract which does not entail manufacture or supply of an article or thing (e.g. a construction contract).

It may be noted that the term "work" would include manufacturing or supplying a product according to the requirement or specification of a customer by using material purchased from such customer or its associate. In such a case, tax shall be deducted on the invoice value excluding the value of material purchased from such customer or its associate, if such value is mentioned separately in the invoice. Where the material component has not been separately mentioned in the invoice, tax shall be deducted on the whole of the invoice value.

17.3. Section 194 J [Fees for Professional or Technical Services]

Every person other than an individual or a HUF, who is responsible for paying to a resident any sum by way of –

- (i) fees for professional services; or
- (ii) fees for technical services; or
- (iii) any remuneration or fees or commission, by whatever name called, other than those on which tax is deductible under section 192, to a director of a company; or
- (iv) royalty, or
- (v) non-compete fees referred to in section 28(va) shall deduct tax at source at the rate of

(a) 2% in case of fees for technical services (not being professional services) or royalty where such royalty is in the nature of consideration for sale, distribution or exhibition of cinematographic films; and
(b) 10% in other cases.

However, in case of a payee, engaged only in the business of operation of call centre, the tax shall be deducted at source @ 2%.

3.3.1. Time of Deduction

The deduction is to be made at the time of credit of such sum to the account of the payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier.

Where any sum is credited to any account, whether called suspense account or by any other name, in the books of accounts of the person liable to pay such sum, such crediting shall be deemed to be credit of such sum to the account of the payee and tax has to be deducted accordingly.

3.3.2. Threshold Limit for Section 194 J

No tax deduction is required if the amount of fees or the aggregate of the amounts of fees credited or paid or likely to be credited or paid during a financial year does not exceed Rs. 30,000 the case of fees for professional services, Rs. 30,000 in the case of fees for technical services, Rs. 30,000 in the case of royalty and Rs. 30,000 in the case of non-compete fees.

The limit of Rs. 30,000 under section 194J is applicable separately for fees for professional services, fees for technical services, royalty and non-compete fees referred to in section 28(va). It implies that if the payment to a person towards each of the above is less than Rs. 30,000, no tax is required to be deducted at source, even though the aggregate payment or credit exceeds Rs. 30,000 to such person. However, there is no such exemption limit for deduction of tax on any remuneration or fees or commission payable to director of a company.

3.3.3. Non-applicability

(i) An individual or a Hindu undivided family is not liable to deduct tax at source. However, an individual or HUF, whose total sales, gross receipts or turnover from business or profession carried by him exceeds Rs. 1 crore in case of business or Rs. 50 lakhs in case of profession in the financial year immediately preceding the financial year in which the fees for professional services or fees for technical services is credited or paid is required to deduct tax on such fees.

(ii) Further, an individual or Hindu Undivided family, shall not be liable to deduct income-tax on the sum payable by way of fees for professional services, in case such sum is credited or paid exclusively for personal purposes.

In the case of CIT v. Kotak Securities Ltd (2016) 383 ITR 1 (SC) the Supreme Court dealt on whether transaction charges paid by the members of the stock exchange for availing fully automated online trading facility, being a facility provided by the stock exchange to all its members, constitute fees for technical services to attract the provisions of tax deduction at source under section 194J.

It observed that technical services like managerial and consultancy service are in the nature of specialised services made available by the service provider to cater to the special needs of the customer-user as may be felt necessary. It is the above feature that would distinguish or identify a service provider from a facility offered.

The Apex Court, accordingly, held that the service provided by the BSE for which transaction charges are paid failed to satisfy the test of specialized, exclusive and individual requirement of the user or the consumer who may approach the service provider for such assistance or service.

Therefore, the transaction charges paid to BSE by its members are not for technical services but are in the nature of payments made for facilities provided by the stock exchange. Such payments would, therefore, not attract the provisions of tax deduction at source under section 194J.

3.4 Section 195 [Any Other Sums Payable to Non-Residents]

Any person responsible for paying interest (other than interest referred to in section 194LB or section 194LC or section 194LD) or any other sum chargeable to tax (other than salaries) to a non-corporate non-resident or to a foreign company is liable to deduct tax at source at the rates prescribed by the relevant Finance Act. Such persons are also required to furnish the information relating to payment of any sum in such form and manner as may be prescribed by the CBDT.

Payee to be a non-resident - In order to subject an item of income to deduction of tax under this section, the payee must be a non-corporate non-resident or a foreign company.

Payer may be a resident or non-resident - Under section 195(1), the obligation to deduct tax at source from interest and other payments to a non-resident, which are chargeable to tax in India, is on “any person responsible for paying to a non-resident or to a foreign company”.

The words “any person” used in section 195(1) is intended to include both residents and non-residents. Therefore, a non-resident person is also required to deduct tax at source before making payment to another non-resident, if the payment represents income of the payee non-resident, chargeable to tax in India. Therefore, if the income of the payee non-resident is chargeable to tax, then tax has to be deducted at source, whether the payment is made by a resident or a non-resident.

Explanation 2 clarifies that the obligation to comply with section 195(1) and to make deduction thereunder applies and shall be deemed to have always applied and extends and shall be deemed to have always extended to all persons, resident or non-resident, whether or not the non-resident has:-

(i) a residence or place of business or business connection in India; or

(ii) any other presence in any manner whatsoever in India.

3.4.1. Time of Deduction

The tax is to be deducted at source at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier.

Where any interest or other sum as aforesaid is credited to any account, whether called "Interest payable account" or "Suspense account" or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee.

However, in the case of interest payable by the Government or a public sector bank within the meaning of section 10(23D) or a public financial institution within the meaning of section 10(23D), deduction of tax shall be made only at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode.

3.4.2. Payment Subject to Tax Deduction

The statutory obligation imposed under this section would apply for the purpose of deduction of tax at source from any sum being income assessable to tax (other than salary income) in the hands of the non-resident non-corporate/foreign company.

Payment to a non-resident by way of royalties and payments for technical services rendered in India are common examples of sums chargeable under the said provisions of the Act to which the liability for deduction of tax at source would apply.

3.4.3. Certificate of Non-deduction of Tax at Source

(i) Under section 195(3), any person entitled to receive any interest or other sum on which income-tax has to be deducted under section 195(1) may make an application in the prescribed form to the Assessing Officer for grant of certificate authorizing him to receive such interest or other sum without deduction of tax thereunder.

(ii) Where any such certificate is granted, every person responsible for paying such interest or other sum to the person to whom certificate is granted make payment of such interest or other sum without deduction of tax at source under section 195(1), so long as the certificate in force.

(iii) Such certificate shall remain in force till the expiry of the period specified therein. However, if it is cancelled by the Assessing Officer before the expiry of such period, the certificate shall remain in force till such cancellation.

(iv) The CBDT is empowered to make rules specifying the cases in which, and the circumstances under which, an application may be made for the grant of certificate. While doing so, it should take into account the convenience of the assessees and the interests of the revenue.

(v) Such Rules would provide for the conditions subject to which such certificate may be granted and any other matter connected therewith.

Section 195(6) provides that the person responsible for paying any sum, whether or not chargeable to tax under the provisions of the Act, to a non-corporate non-resident or to a foreign company, shall be required to furnish the information relating to payment of such sum in the prescribed form and prescribed manner.

3.4.4. Specified class or classes of persons, making payment to the Non-resident, to mandatorily make application to Assessing Officer to determine the appropriate proportion of sum chargeable to tax

(i) Under section 195(1), any person responsible for paying to a non-corporate non-resident or to a foreign company, any interest or any other sum chargeable under the provisions of the Act (other than salary), has to deduct tax at source at the rates in force.

(ii) Under section 195(2), where the person responsible for paying any such sum chargeable to tax under the Act (other than salary) to a non-resident, considers that the whole of such sum would not be income chargeable in the hands of the recipient, he may make an application in such form and manner to the Assessing Officer, to determine in such manner, as may be prescribed, the appropriate proportion of such sum so chargeable. When the Assessing Officer so determines, the appropriate proportion, tax shall be deducted under section 195(1) only on that proportion of the sum which is so chargeable.

(iii) Consequent to the retrospective amendments in section 2(47), section 2(14) and section 9(1) by the Finance Act, 2012, section 195(7) provides that, notwithstanding anything contained in sections 195(1) and 195(2), the CBDT may, by notification in the Official Gazette, specify a class of persons or cases, where the person responsible for paying to a non-corporate non-resident or to a foreign company, any sum, whether or not chargeable under the provisions of this Act, shall make an application in the prescribed form and manner to the Assessing Officer, to determine in the prescribed manner, the appropriate proportion of sum chargeable to tax. Where the Assessing Officer determines the appropriate proportion of the sum chargeable, tax shall be deducted under sub-section (1) on that proportion of the sum which is so chargeable.

(iv) Consequently, where the CBDT specifies a class of persons or cases, the person responsible for making payment to a non-corporate non-resident or a foreign company in such cases has to mandatorily make an application in the prescribed form and manner to the Assessing Officer, whether or not such payment is chargeable under the provisions of the Act.

3.4.5. Procedure for Refund of TDS under Section 195 to the person deducting tax in cases where tax is deducted at a higher rate prescribed in the DTAA

The CBDT has, through Circular No. 7/2011 dated 27.9.2011, modified Circular No. 07/2007, dated 23.10.2007 which laid down the procedure for refund of tax deducted at source under section 195 of the Income-tax Act, 1961 to the person deducting tax at source from the payment to a non-resident. The said Circular allowed refund to the person making payment under section 195 in the circumstances indicated below where, after the deposit into Government account of the tax deducted at source under section 195,

(a) the contract is cancelled, and no remittance is made to the non-resident;
(b) the remittance is duly made to the non-resident, but the contract is cancelled. In such cases, the remitted amount has been returned to the person responsible for deducting tax at source;
(c) the contract is cancelled after partial execution and no remittance is made to the non-resident for the non-executed part;
(d) the contract is cancelled after partial execution and remittance related to non-executed part is made to the non-resident. In such cases, the remitted amount has been returned to the person responsible for deducting the tax at source or no remittance is made but tax was deducted and deposited when the amount was credited to the account of the non-resident;
(e) there occurs exemption of the remitted amount from tax either by amendment in law or by notification under the provisions of Income-tax Act, 1961;
(f) an order is passed under section 154 or 248 or 264 of the Income-tax Act, 1961 reducing the tax deduction liability of a deductor under section 195;
(g) there occurs deduction of tax twice from the same income by mistake;
(h) there occurs payment of tax on account of grossing up which was not required under the provisions of the Income-tax Act, 1961;
(i) there occurs payment of tax at a higher rate under the domestic law while a lower rate is prescribed in the relevant double taxation avoidance treaty entered into by India.

In the cases mentioned above, income does not either accrue to the non-resident or it accrues but the excess amount in respect of which refund is claimed, is borne by the deductor. The amount deducted as tax under section 195 and paid to the credit of the Government therefore belongs to the deductor.

In the type of cases referred to in (a), the non-resident not having received any payment would not apply for a refund. For cases covered in (b) to (i), no claim may be made by the non-resident where he has no further dealings with the resident deductor of tax or the tax is to be borne by the resident deductor. The resident deductor was therefore put to genuine hardship as he would not be able to recover the amount deducted and deposited as tax.

In the type of cases referred to above, where no income has accrued to the non- resident due to cancellation of contract or where income has accrued but no tax is due on that income or tax is due at a lesser rate, the amount deposited to the credit of Government to that extent under section 195, cannot be said to be "tax".

Therefore, the CBDT decided that this amount can be refunded, with prior approval of the Chief Commissioner of Income-tax or the Director General of Income-tax concerned, to the person who deducted it from the payment to the non-resident, under section 195.

Refund to the person making payment under section 195 is being allowed as income does not accrue to the non-resident or if the income is accruing no tax is due or tax is due at a lesser rate. The amount paid into the Government account in such cases to that extent, is no longer "tax". In view of this, no interest under section 244A is admissible on refunds to be granted in accordance with this circular.

In case of refund being made to the person who made the payment under section 195, the Assessing Officer may, after giving intimation to the deductor, adjust it against any existing tax liability of the deductor under the Income-tax Act, 1961, Wealth-tax Act, 1957 or any other direct tax law. The balance amount, if any, should be refunded to the person who made such payment under section 195.

A refund in terms of this circular should be granted only after obtaining an undertaking that no certificate under section 203 of the Income-tax Act has been issued to the non-resident. In cases where such a certificate has been issued, the person making the refund claim under this circular should either obtain it or should indemnify the Income-tax Department from any possible loss on account of any separate claim of refund for the same amount by the non-resident. A refund in terms of this circular should be granted only if the deductee has not filed return of income and the time for filing of return of income has expired.

The refund as per this circular is, inter alia, permitted in respect of transactions with non-residents, which have either not materialized or have been cancelled subsequently. It, therefore, needs to be ensured by the Assessing Officer that they disallow corresponding transaction amount, if claimed, as an expense in the case of the person, being the deductor making refund claim. Besides, in all cases, the Assessing Officer should also ensure that in the case of a deductor making the claim of refund, the corresponding disallowance of expense amount representing TDS refunded is made.

The said Circular, however, did not cover a situation where tax is deducted at a rate prescribed in the relevant DTAA which is higher than the rate prescribed in the Income-tax Act, 1961. Since the law requires deduction of tax at a rate prescribed in the relevant DTAA or under the Income-tax Act, 1961, whichever is lower, there is a possibility that in such cases excess tax is deducted relying on the provisions of relevant DTAA. Accordingly, in order to remove the genuine hardship faced by the resident deductor, the CBDT has modified Circular No.

07/2007, dated 23-10-2007 to the effect that the beneficial provisions under the said Circular allowing refund of tax deducted at source under section 195 to the person deducting tax at source shall also apply to those cases where deduction of tax at a higher rate under the relevant DTAA has been made while a lower rate is prescribed under the domestic law.

3.5. Section 197 [Certificate for Deduction of Tax at a Lower Rate]

This section applies where, in the case of any income of any person or sum payable to any person, income-tax is required to be deducted at the time of credit or payment, as the case may be at the rates in force as per the provisions of sections 192, 193, 194, 194A, 194C, 194D, 194G, 194H, 194-I, 194J, 194K, 194LA, 194LBB, 194LBC, 194M, 194-O and 195. In such cases, the assessee can make an application to the Assessing Officer for deduction of tax at a lower rate or for non-deduction of tax.

If the Assessing Officer is satisfied that the total income of the recipient justifies the deduction of income-tax at lower rates or no deduction of income-tax, as the case may be, he may give to the assessee such certificate, as may be appropriate. Where the Assessing Officer issues such a certificate, then the person responsible for paying the income shall deduct income-tax at such lower rates specified in the certificate or deduct no tax, as the case may be, until such certificate is cancelled by the Assessing Officer. Enabling powers have been conferred upon the CBDT to make rules for prescribing the procedure in this regard.

Test Your Knowledge

QUESTIONS	
1.	KP Limited paid leave travel facility to its employees and considered exemption under section 10(5), based on the self-declaration furnished by the employees. The Assessing Officer held that the company as an employer ought to have verified the genuineness of the claim of exemption by obtaining from them, the proof of actual expenditure incurred by availing leave travel facility. Accordingly, the Assessing Officer treated the assessee company as assessee in default. Decide the correctness of action.
2.	B Ltd. purchased jute bags from Maharaja & Co. The latter has to supply the jute bags with the logo and address of the assessee, printed on it. From 01.09.2021 to 20.03.2022, the value of jute bags supplied is Rs. 8,00,000, for which the invoice has been raised on 20.03.2022. While effecting the payment for the same, is the assessee bound to deduct tax at source, assuming that the value of the printing component involved is Rs. 1,10,000? You are informed that the assessee has not sold any material to Maharaja & Co. and that the latter has to manufacture the jute bags in its plant using raw materials purchased by it from outsiders.
3.	Mimo Ltd. makes the following payments to Mr. A, a contractor, for contract work during the P.Y. 2021-22– Rs. 20,000 on 1.5.2021 Rs. 25,000 on 1.8.2021 Rs. 28,000 on 1.12.2021 On 1.3.2022, a payment of Rs. 30,000 is due to Mr. A on account of a contract work. Discuss whether Mimo Ltd. is liable to deduct tax at source under section 194C from payments made to Mr. A.
4.	Examine the applicability of the provisions relating to deduction of tax at source in the following transaction. Lila Ltd., a foreign company, pays outside India, salary to its employee, Mr. R, a foreign national and a non-resident, for services rendered in India.

SOLUTIONS	
1.	Section 192 casts liability on the employer to deduct tax at source from the salary paid to its employees. In this case, the employer has paid leave travel concession/ facility to its employees and the said concession/ facility would be eligible for exemption subject to the conditions laid down in section 10(5) read with Rule 2B of the Income-tax Rules, 1962. Section 192(2D) casts responsibility on the person responsible for paying any income chargeable under the head 'Salaries' to obtain from the assessee, the evidence or proof or particulars of prescribed claims under the provisions of the Act in the prescribed form and manner for the purposes of – *(i)* estimating income of the assesses; or *(ii)* computing tax deductible under section 192(1). In the given case, KP Limited paid leave travel concession to its employees and considered for exemption on the basis of mere self-declaration, instead of verifying and obtaining the evidences/proof of actual expenditure. Thus, the action of the Assessing Officer is correct in law.
2.	As per the definition under section 194C, "work" shall not include manufacturing or supplying a product according to the requirement or specification of a customer by using raw material purchased from a person, other than such customer or associate of such customer. This is regardless of the quantum of expenditure incurred towards printing or processing comprised in the bill amount. The problem clearly states that Maharaja & Co. has to manufacture the jute bags using raw materials purchased from outsiders and that the assessee B Ltd. has not sold any material to them. Therefore, in this case, it is a contract of sale. Hence, the provisions of section 194C are not attracted and no liability to deduct tax at source would arise.
3.	In this case, the individual contract payments made to Mr. A does not exceed Rs 30,000. However, since the aggregate amount paid to Mr. A during the P.Y. 2021-22 exceeds Rs. 1,00,000 (on account of the last payment of Rs 30,000, due on 1.3.2022, taking the total from Rs 73,000 to Rs 1,03,000), the TDS provisions under section 194C would get attracted. Tax has to be deducted @ 1% on the entire amount of Rs 1,03,000 from the last payment of Rs 30,000 and the balance of Rs. 28,970 (i.e., Rs. 30,000 – Rs. 1030) has to be paid to Mr. A.
4.	Section 195 requires deduction of tax at source by any person responsible for making payment to a non-resident, any interest or any other sum chargeable under the provisions of the Income-tax Act, 1961 (other than income chargeable under the head "Salaries").

	Section 192(1) requires “any person” responsible for paying income under the head “Salaries” to deduct tax at source. Therefore, even if the payer is a foreign company, section 192 would be applicable. TDS provisions under section 192 are attracted, if the salary payable to a non-resident is chargeable to tax in India. Under section 9(1)(ii), income which falls under the head "Salaries" shall be deemed to accrue or arise in India, if it is earned in India. Salary payable for service rendered in India shall be regarded as income earned in India. Therefore, salary paid to Mr. R, a non-resident, attracts tax liability in India, as he has rendered services in India and the salary is attributable to such services. Therefore, the foreign company, Lila Limited, is liable to deduct tax at source under section 192 from the salary of Mr. R.