Centre for Tax Laws (CTL)
Directorate of Distance Education
NALSAR University of Law, Hyderabad
In collaboration with
TAXMANN

Course Material

M.A. (INTERNATIONAL TAXATION)

2.3.9. INCOME FROM EQUITY AND DEBT INVESTMENT

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(For private circulation only)

NALSAR University of Law, Hyderabad (Print 2022)

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Income from Equity and Debt Instruments

Module I – Dividends

1. Introduction

Dividends constitute a significant stream of income for shareholders of companies. Double taxation of income – first, in the hands of the companies and thereafter in the hands of the shareholders on distribution as dividend is prevalent worldwide. The manner in which dividend income is taxed in India has undergone several changes over the years. In 1997, India introduced the Dividend Distribution Tax ('DDT') regime wherein dividend income was exempt in the hands of the shareholders but the company paying the dividend was required to pay DDT at a flat rate (irrespective of the tax rate applicable to respective shareholders). Ease of tax collection on dividends at a single point was a prime reason for such a move. However, this methodology was considered regressive and inequitable, as dividend is income in the hands of the shareholder and not in the hands of the company. In 2002, the incidence of dividend tax was shifted to the shareholders and again shifted back in the hands of the company in 2003.

India has now re-introduced the classical system of taxing dividends in the hands of the shareholders as was prevalent in the past. The classical system of taxing dividends will be effective from Financial Year ('FY') 2020-21 and will apply to dividends distributed on or after 1 April 2020. As stated by the Hon'ble Finance Minister in her Budget Speech, the removal of DDT will lead to estimated annual revenue foregone of INR 25,000 crore. Higher personal and corporate tax collections on account of taxation of dividend in the hands of shareholders will compensate the loss on account of DDT. Whilst the former DDT regime had the advantage of ease of tax collection, it significantly increased the cost of doing business in India; especially for foreign investors, as there were issues on availing credit of DDT in their home jurisdiction (given that DDT was a tax on the company and not on the shareholders) and thereby leading to double taxation in many cases. The effective DDT rate of 20.56% was also significantly higher than the maximum rate at which India would have had the right to collect tax under most of the relevant tax treaties. Given the re-introduction of the classical system of taxing dividends coupled with reduced corporate tax regimes introduced in 2019, India certainly has emerged as an attractive destination for foreign investors. This should augur well in attracting companies seeking to diversify their global supply chains due to COVID-19.

2. Definition of Dividend [Paragraph 3 of Article 10]

Paragraph 3 of Article 10 provides that the term "dividends" as used in Article 10 means income from shares or other rights not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

The OECD Model defines the term dividend to includes income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares; or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

US Model defines the term dividend to include income from shares, or other rights, not being debt-claims, participating in profits, as well as income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident.

3. Allocation Rule [Paragraph 1 of Article 10]

Paragraph 1 of Article 10 lays down the principle that dividend paid by a company which is resident of a Contracting State (say country S) to a resident of the other Contracting State (say Country R) may be taxed in that other state (i.e. in country R).

Thus, any assesse who receives dividend from a company situated in country other than the resident country can be taxed at the resident country.

4. Concept of 'Paid', 'May be Taxed' and 'Beneficial Owner'

As per OECD commentary (Para 7 of Article 10), the term 'paid' has a very wide meaning, since the concept of payment means the fulfillment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or custom.

As mentioned in Article 3(2), the meaning of the terms which are not defined in the treaty can be taken as per domestic tax laws. Therefore, where the term paid is not defined, the meaning can be taken from the domestic tax laws.

4.1. The Concept of 'Paid' in Indian Tax Laws

As per Section 42(2) of Income Tax Act, 1961, 'paid' means actually paid or incurred according to method of accounting.

ITAT observed that the term 'paid' has not been defined in the treaty, hence, it should be assigned domestic law meaning under Article 3(2) of the treaty. The term 'paid is defined under section 43(2) to mean "actually paid or incurred according to the method of accounting".

All the coordinate bench decisions on this issue and also Bombay HC decision in case of **DIT vs. Siemens AG** are rendered without considering Article 3(2) & Section 43(2) and could possibly be per incuriam. ITAT referred to **Standard Triumph Motor Co. Ltd. [1993] 201 ITR 391** wherein the SC held that the credit entry in the assessee's books does amount to receipt for the recipient in UK.

ITAT felt that it is indeed worth exploring as to whether the meaning assigned to the expression “received by an assessee”, which essentially corresponds to and has to treated as equivalent to “paid to the payee", by SC in Standard Triumph is to be assigned to the treaty of the undefined treaty expression "paid".

ITAT noted that this aspect remained unexamined in co-ordinate bench and Bom HC decisions. Recommendation has been made for constitution of a special bench. ITAT noted that in the event of a doubt about the correctness of the earlier decision or, extending that logic a little further, correctness of the path the earlier decisions have traversed to come to a conclusion, it is open to the bench to make a reference to for constituting a larger bench for considering the same.

4.2. The Concept of “May be Taxed”

The terms ‘may be’ and ‘shall be’ have always been at loggerheads in tax litigation. These have also been favourite topics to fight for by the legal luminaries. One can find a number of judgments from the Apex Court, various High Courts and fallout of these judgments in the form of a number of decisions of various Benches of the Tribunal. What happens when the interpretations of these terms are sought in the context of interpreting the Double Taxation Avoidance Agreements entered into between India and other countries? Invariably in all the tax treaties entered into by India, one can see that there are a few articles which talk about an income which ‘shall be’ taxed in a particular contracting State. However there are a few Articles whereby certain incomes ‘may be’ taxed in a particular contracting State. Present write-up is an attempt to dig out the reasoning for use of such variance in terminology and the practical impact on the taxability of income of the same.

Under Article 245(1) of the Indian Constitution, Parliament is empowered to make laws for the whole or any part of the territory of India and the Legislature of a State is empowered to make laws for the whole or any part of the State, subject to the provisions of the Constitution. These legislative powers are distributed between Parliament and the State Legislatures, in terms of Lists I, II and III of the 7th Schedule. Article 51(c), which is part of the Directive Principles of State Policy, obliges the State to endeavour to foster respect for International Law and Treaty obligations. Article 253 is an enabling provision that empowers Parliament to make any law for the whole or any part of the territory of the country for implementing any treaty, agreement or convention with any other country.

India has comprehensive Double Taxation Avoidance Agreements with various countries. The Double Taxation Avoidance Agreements that India has entered into with various countries stipulate agreed rate of tax and jurisdiction on specified types of income arising in a country to tax resident of another country. Section 90 of the Income-tax Act is specifically intended to enable and empower the Central Government to issue a Notification for the implementation of a Double Taxation Avoidance Agreement and hence, as a consequence, the provisions of such an agreement would operate even if inconsistent with the provisions of the Income-tax Act. Section 90 of the Act gives relief to the taxpayers who have paid the tax to a country with which India has signed the Double Taxation Avoidance Agreement. It also confers the power on the Central Government to enter into any agreement with the Government of another country for granting relief to an assessee who has paid income tax under the Act and also income tax in that other country and also in respect of income tax which is chargeable under the Act and under the corresponding law of that country. This has been done with a view to promote mutual economic relations, trade and investment and for avoidance of double taxation of income under the Income-tax Act as well as the Act of the other contracting State. Section 90(2) lays down that where the Central Government has entered into an agreement with the Government of any other country for granting relief of tax or for avoidance of double taxation, then the provisions of Income-tax Act shall apply to the assessee only to the extent they are more beneficial to it. In case the provisions of the Act are more onerous and burdensome, then the provisions of the same would not apply and the assessee would be governed squarely by the provisions of the double taxation avoidance agreement.

On this aspect, Chennai Bench of the ITAT in the case of ***Sivagami Holdings P. Ltd. v. ACIT – [2011] 10 ITR (Trib.) 48 (Chennai)*** has held that the DTAA is entered into between the countries only for the limited purpose of avoiding the hardship of double taxation and if the income is not taxed in the contracting State, the same should be taxed in India is an oversimplified statement on the whole regime of Double Taxation Avoidance Agreement. It is true that the prime motivating factor in developing the concept of Double Taxation Avoidance Agreement is the genuine hardship of the international assessee that the same amount of income became the subject of taxation both in the home State and in the contracting State. It is to alleviate this burden of double taxation that the instrument of Double Taxation Avoidance Agreement has evolved through the process of law.

It is to be understood that treaties entered into between two nations are just agreements entered into between two parties and they get the colour of legally bound nature from the relevant provisions in any nation's local law. The rules of interpretation of statutes cannot be strictly applied while interpreting these treaties. The treaties are to be read in consonance with the intention of the parties, i.e., the contracting States, entering into the same.

As has already been stated herein above that there are instances under the DTAAs where the terminology used is 'shall be taxed'. In such cases, there cannot be any doubt as to the position that the income has to be taxed in that state only. But what happens in case the term used is 'may be taxed'? The questions that arise are whether this does not give absolute power to that State to tax such incomes or whether it intends to give equal power to both the States to tax the same income or it snatches away the power to tax from one State to another?

This issue, for the first time, came up for consideration before the Karnataka High Court in **CIT v. R. M. Muthaiah (1993) 202 ITR 508 (Kar.)**, which was in relation to Indo-Malaysian DTAA. Here also, the High Court had an occasion to deal with the phrase "may be taxed" as given in Article-VI(1) which, at the relevant time, read as "income from immovable property may be taxed in the Contracting State in which such property is situated". The High Court held that the result of this clause is that where the income from immovable property in

Malaysia has been expressed as “may be taxed” by the Government of Malaysia, then it operates as a bar on the power of the Indian Government to tax such income. This bar would operate in sections 4 & 5 of the Income-tax Act, 1961 also. The High Court has also drawn its inference from the language of sub-sections (a) and (b) of section 90 wherein, the former reference is for granting of relief in respect of the income on which income tax has been paid both under the domestic law and under the laws of other countries and later clause refers to avoidance of double taxation which means once tax has been paid to the other contracting State then no tax is to be paid here in India. This distinction, it was held that, has to be taken into consideration while deciding this issue because once the assessee has paid tax in other Contracting State in terms of the agreement, then by necessary implications, Indian Government cannot levy tax on the same income.

Since the department did not go in appeal against this decision, before the Supreme Court, it has attained finality and this fact has also been noted down by the Apex Court in the landmark judgment in the case of ***Azadi Bachao Andolan reported in 263 ITR 707 (SC).***

The issue, later, arose in the year 1994 regarding taxation of capital gains and business incomes, arising from sources in Malaysia, to a Hindu Undivided Family from south of India, which was resident in India, before Madras High Court in the case of ***CIT v. VR. S.R.M Firm 208 ITR 4 (Mad.)***. During the year certain business income as well as capital gains on sale of an immovable property situated in Malaysia arose to the assessee firm. The Assessing Officer proceeded only on the basis of the provisions of Indian domestic law that since assessee was resident of India and hence global income is to be taxed, taxed both these incomes in assessee’s hands. On assessee’s reliance on the DTAA between India and Malaysia whereby these incomes were provided to be ‘may be taxed’ in Malaysia, the A.O. was of the view that it is only ‘may be’ taxed, therefore the resident State has the absolute right to tax.

On appeal, the High Court pointed out that Article XXII(1) of the agreement with Malaysia declares that the laws in force in either of the contracting States will continue to govern the taxation of income in the respective States except where provisions to the contrary are made in the agreement. Therefore, where there exists a provision to the contrary in the agreement, there is no scope for applying the domestic law. The Court, further, observed that sections 22 to 27 of the Income-tax Act broadly deal with the income from house property. But in view of Paragraph 1 of Article VI of the agreement between India and Malaysia, income from immovable property can be taxed only in and by the contracting State where the property is situated. There is no scope for the other contracting State to deal with such income. Further, on the interpretation of the term ‘may be’ on which heavy reliance was placed by the revenue, Hon’ble High Court observed as under:

“The contention on behalf of the Revenue that wherever the enabling words such as “may be taxed” are used there is no prohibition or embargo upon the authorities exercising powers under the Income-tax Act, 1961, from assessing the category or class of income concerned cannot be countenanced as of substance or merit. As rightly pointed out on behalf of the assessees, when referring to an obvious position such enabling form of language has been liberally used and the same cannot be taken advantage of by the Revenue to claim for it a right to bring to assessment the income covered by such clauses in the agreement, and that the mandatory form of language has been used only where there is room or scope for doubts or more than one view possible, by identifying and fixing the position and placing it beyond doubt."

Revenue carried the matter in appeal before Apex Court in the case reported as **CIT v. P.V.A.L. Kulandagan Chettier (2004) 267 ITR 654 (SC)**. The Apex Court observed that when it is intended under the DTAA that even though it is possible for a resident in India to be taxed in terms of sections 4 and 5 of the Act, if he is deemed to be a resident of a contracting State where his personal and economic relations are closer, then his residence in India would become irrelevant. In terms of the DTAA, wherever any expression is not defined in the agreement, the expression defined in the Income-tax Act would be attracted. Since income includes capital gains under the domestic law, capital gains derived from immovable property situated in Malaysia would be income under the DTAA and, Article VI would be attracted. With regard to the argument as to the interpretation of phrase 'may be' raised by department, the Apex Court held as under:

"We need not enter into an exercise in semantics as to whether the expression "may be" will mean allocation of power to tax or is only one of the options and it only grants power to tax in that State and unless tax is imposed and paid, no relief can be sought. Reading the treaty in question as a whole, when it is intended that even though it is possible for a resident in India to be taxed in terms of sections 4 and 5, if he is deemed to be a resident of a contracting State where his personal and economic relations are closer, then his residence in India will become irrelevant, the treaty will have to be interpreted as such and prevails over sections 4 and 5 of the Act. Therefore, we are of the view that the High Court is justified in reaching its conclusion, though for different reasons from those stated by the High Court."

In this way, though, the Apex Court refrained itself from giving a precise meaning to the term 'may be', the order of the High Court was confirmed on a different line.

The bilateral double taxation agreements generally lay down two situations, in the first situation an assessee may be required to pay tax in the country of residence and is exempted in the country in which the income arises. In the other situation the country where the income arises deducts tax at source and the taxpayer receives compensation in the form of a foreign tax credit in the country of residence which would entitle the taxpayer to a credit in the country of residence to the extent the income that has been taxed in the country where the income has so arisen. To be able to avail the benefit of foreign tax credit the assessee has to declare himself (in the country where income has arisen) to be a non-resident.

It is to be kept in mind that the treaties are entered into between the two nations primarily to avoid double taxation of a single instance of income by both the states simultaneously. There are two methods of elimination of double taxation. Exemption or Avoidance Method provides to tax one income in only one of the States. Wherever the term used in the DTAA is 'shall be taxed' or 'shall not be taxed' or 'shall be exempt 'etc., the avoidance method for elimination of double taxation is being perceived. These Articles remain uncontroversial in view of such clear language. The other method of elimination of double taxation is the 'Credit Method'. Whenever an income is taxed by both the contracting States, the credit of taxes paid by the assessee in the other contracting State will be given by the State in which the assessee is a resident. The term 'may be taxed' in fact contemplates this method of elimination of double taxation.

These two rules have been explained in para 19 of OECD commentary under the title taxation of income and capital read as under:

"19. For the purpose of eliminating double taxation, the Convention establishes two categories of rules. First, Articles 6 to 21 determine, with regard to different classes of income, the respective rights to tax of the State of source or situs and of the State of residence, and Article 22 does the same with regard to capital. In the case of a number of items of income and capital, an exclusive right to tax is conferred on one of the contracting States. The other contracting State is thereby prevented from taxing those items and double taxation is avoided. As a rule, this exclusive right to tax is conferred on the State of residence. In the case of other items of income and capital, the right to tax is not an exclusive one. As regards two classes of income (dividends and interest), although both States are given the right to tax, the amount of tax that may be imposed in the State of source is limited. Second, insofar as these provisions confer on the State of source or situs a full or limited right to tax, the State of residence must allow relief – as to avoid double taxation; this is the purpose of Articles 23A and 23B. The Convention leaves it to the contracting States to choose between two methods of relief, i.e. the Exemption Method and the Credit Method."

It can by no stretch of imagination be perceived that whenever it is said that a certain income 'may be taxed' in a particular State, it may mean that the said income is not to be taxed in that particular State or only the other contracting State has the power to tax the said income. The reason is simply the fact that the treaties are drafted by the people possessing high degree of legal prudence. If this is the case, who stopped them to provide in the relevant Article the taxability in the intending state by using the words like 'shall be' or 'will be'. Such an interpretation will be defeat of all common principles of interpretation of statute or of simple agreements.

Pune Bench of the Tribunal, in **DCIT v. Patni Computer System Ltd. [2008] 114 ITD 159 (Pune)**, has categorically specified that the decision of R.M. Muthaiah (supra) and S.R.M. Firm & Ors. (supra) lays down the prevailing legal position in India which has been affirmed by the Hon'ble Supreme Court in Azadi Bachao Andolan (supra) and P.V.A.L. Kulandagan Chettiar (supra) that once the income is held to be taxable in a tax jurisdiction under the DTAA, unless there is a specific mention that it can also be taxed in the other tax jurisdiction, the other tax jurisdiction is denuded of its power to tax the same.

ITAT Mumbai Bench 'L' in the case of **Ms Pooja Bhatt v. DCIT [2008] 26 SOT 574 (Mumbai)** held that when the film artist assessee is a resident of India who had participated in an entertainment show performed in Canada in the year under consideration i.e. 1994-95 and had received certain sum for the participation and tax was also deducted at source in Canada in respect of said receipt/income, then in this situation, in view of Article 18 of DTAA between India and Canada, amount so received by the assessee could not be taxed in India. ITAT, Mumbai Bench interpreting the expression "may be taxed" in para 1 in Article 18 held that this expression gives only an option to the other contracting state to tax the income but does not preclude the contracting state of residence to assess the said income. Accordingly, such expression authorizes only contracting state of source to tax such amount and by necessary implication the contracting state of residence is precluded from taxing such income.

For getting benefit of a tax treaty, one has to read the treaty with respect to the income, taxability of which has to be taxed. The relevance of the term 'may be taxed' lies on the fact that the subject income may be or may not be exigible to tax as per local laws of the state in which it is provided to be 'may be' taxed. Since the DTAAs are meant to provide and are applicable only to the extent more beneficial to a subject than the local laws. In such a scenario income which is not taxable under the local laws of a state is not desirable to be taxed as per the DTAA. In this context judicial interpretation given to such situations that one need not go to the DTAA if a certain income is not taxable as per the Income Tax Act, is useful. Therefore, the desired conclusion emerges that in a situation where an income 'may be' taxed in a particular state, it should be taxed in that state only if it is also taxable as per its local law.

It should be kept in mind that the term 'may be' has been placed mainly in those articles concerning taxability of those incomes, on which the source state has a limited right of taxation, i.e. to the extent the income is attributable to the activities carried out in that state only. This fact also leaves open the right of taxation to the resident state also to a certain extent.

This inference may simply be drawn from the fact that in a situation where an income is not taxed in the particular state in which it is provided to 'may be' taxed because of it not being taxed as per the local laws, the other contracting state also not taxing the same may provide for elimination even once the taxation of income. The logical conclusion is that in cases of income 'may be' taxed in a particular state, that state gets the first right to tax the same. However both the States are equally entitled to tax the same and in such a scenario the elimination of double taxation regime comes into picture.

Chennai Bench of the Tribunal in **ITO v. M/s. Data Software Research Co. Pvt. Ltd. ITA No. 2072/Mum./2006, order dated 27th November 2007**, wherein on interpretation of a similar phrase appearing in Indo-U.S. DTAA appeared, has held that if the P.E. of a resident Indian is assessed in U.S.A., it is entitled to tax credit for the tax paid in the contracting State but there is nothing in the DTAA which states that such profit has to be exempted in India.

Thus, the Tribunal was of the opinion that both the countries have the jurisdiction to tax wherever there is an expression “may be taxed”.

4.3. The Concept of “Beneficial Owner”

The concept of ‘beneficial ownership’ is found under the international tax treaties. The tax treaties are negotiated based on the model tax conventions and these conventions inter alia provide explanations as to the intent and purpose behind terms appearing therein. The phrase ‘beneficial owner’ appears in both the OECD Model Tax Convention and the UN Model Tax Convention in the provisions dealing with the following incomes:

i. Dividend;
ii. Interest;
iii. Royalties; and
iv. Fee for technical services (FTS) - this income does not appear in the OECD Model Tax Convention.

Upon satisfaction of beneficial ownership condition, the taxpayers can avail beneficial tax rates as available under the tax treaties in respect of the aforesaid incomes.

The OECD commentary considers a ‘beneficial owner’ to be the person ‘who has the right to use and enjoy that income’. The said right is unfettered of any contractual or legal obligation to pass on the income to another person.

Aligned to the object and purposes of the OECD Convention, direct recipient of the incomes who are agents, nominees or conduits are accepted from being considered as the ‘beneficial owner’. The agents, nominees and conduits are not to be allowed in the form of tax treaty benefits as they are subject to contractual and legal obligations towards their principal or for their restricted powers with respect to the incomes received by them in fiduciary or administrative capacity.

The OECD commentary seems to advocate the use of ‘substance over form’ test to determine beneficial ownership. This understanding of the beneficial ownership test is also borrowed and applied by the UN Model Commentary.

While some courts have adopted the OECD definition of ‘beneficial owner’ as it is, some other courts have further clarified the scope of the term, without compromising with the essence of the OECD definition.

One popular ruling on this issue comes from the Tax Court of Canada in **Prevost Car Inc. v. Her Majesty the Queen, 2008 TCC 231**, which was affirmed by the Federal Court of Appeal. The court herein interpreted the meaning of ‘beneficial owner’ of dividends under the Canada–Netherlands treaty.

As per the court, ‘beneficial owner’ is the true owner who receives the dividends for his/her own use and enjoyment, assumes all attributes of the ownership including the risk and control of the dividend and is not accountable to anyone for how the dividend is used.

Further, if such recipients are companies, the corporate veil is to be pierced only if the company is a conduit for another person and has absolutely no discretion as to the use or application of funds routed through it, or has agreed to act on another person's behalf pursuant to that person's instructions, without any right to do other than what that person instructs it.

The test as laid down in Prevost (supra) was applied by the Tax Court of Canada again in another subsequent decision in **Velcro Canada Inc. v. Her Majesty the Queen, 2012 TCC 57**, to determine the beneficial owner of royalty income arising in the context of the Canada–Netherlands treaty.

Another landmark ruling on this issue comes from the Court of Justice of the European Union (CJEU) in a decision involving six cases, popularly known as the CJEU Danish cases (see the ruling dated February 26 2019 in cases C-115/16, C-118/16, C-119/16 and C-299/16, N Luxembourg 1 and Others and Cases C-116/16 and C-117/17, T Danmark and Y Denmark.).

5. <u>Characterization of Dividends based on Domestic Laws of Source Country</u>

Dividend income is generally chargeable to tax in the source country as well as the country of residence of the assessee and, consequently, country of residence provides a credit of taxes paid by the assessee in the source country. Thus, the dividend income shall be taxable in India as per provisions of the Act or as per relevant DTAA, whichever is more beneficial.

As per most of the DTAAs, India has entered into with foreign countries, the dividend is taxable in the source country in the hands of the beneficial owner of shares at the rate ranging from 5% to 15% of the gross amount of the dividends.

In DTAA with countries like Canada, Denmark, Singapore, the dividend tax rate is further reduced where the dividend is payable to a company which holds specific percentage (generally 25%) of shares of the company paying the dividend. However, no minimum time limit has been prescribed in these DTAAs for which such shareholding should be maintained by the recipient company. Therefore, MNCs were often found misusing the provisions by increasing their shareholding in the company declaring immediately before declaration of the dividend and offloading the same after getting the dividend. India does not face this situation as dividend income is exempt from tax in the hands of the shareholders. However, after the proposed amendment, India too will face the risk of tax avoidance by the foreign company by artificially increasing the holding in the dividend declarant domestic company.

India is a signatory to the Multilateral Convention (MLI) which shall implement the measures recommended by the OECD to prevent Base Erosion and Profit Shifting. MLI is a binding international legal instrument which is envisaged with a view to swiftly implements the measures recommended by OECD to prevent Base Erosion and Profit Shifting in existing bilateral tax treaties in force. With respect to dividend income, Article 8 (Dividend Transfer Transactions) of MLI provides for a minimum period of 365 days for which a shareholder, receiving dividend income, has to maintain its shareholding in the company paying the dividend to get the benefit of the reduced tax rate on the dividend.

As the taxability of dividend is proposed to be shifted from companies to shareholders, the Government has introduced a new section 80M under the Income Tax Act, 1961 to remove the cascading effect where a domestic company receives a dividend from another domestic company. However, nothing has been prescribed where a domestic company receives dividend from a foreign company and further distribute the same to its shareholders. The taxability in such cases shall be as under:

- **Domestic company receives dividend from another domestic company**

The provisions of section 80M removes the cascading effect by providing that inter-corporate dividend shall be reduced from total income of company receiving the dividend if same is further distributed to shareholders one month prior to the due date of filing of return.

- **Domestic company receives dividend from a foreign company**

Dividend received by a domestic company from a foreign company, in which such domestic company has 26% or more equity shareholding, is taxable at a rate of 15% plus Surcharge and Health and Education Cess under Section 115BBD. Such tax shall be computed on a gross basis without allowing deduction for any expenditure.

Dividend received by a domestic company from a foreign company, in which equity shareholding of such domestic company is less than 26%, is taxable at normal tax rate. The domestic company can claim deduction for any expense incurred by it for the purposes of earning such dividend income.

Note: The Finance Act, 2022 has amended the Section 115BBD to provide that the provisions of this section shall not apply to any assessment year beginning on or after 01-04-2023.

6. Force of Attraction on Outbound Dividends Effectively Connected to a PE (Article 10, Paragraph 4)

Paragraph 4 of Article 10 states that the provisions of Paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

Outbound Transaction refers to the tax treatment of a country's residents (and perhaps citizens) doing business and investment.

Under Spanish tax law, domestic dividends (that is, dividends paid by a resident subsidiary to a resident parent company) are not subject to withholding tax, and the parent company is exempt of tax on those dividends, provided that it has a holding of at least 5% for at least one year.

By contrast, outbound dividends (that is, dividends paid by a resident company to a non-resident parent company) are, in principle, subject to a withholding tax at a rate of 18% and the parent company is not granted any exemption on such withholding tax. Where the parent company is resident in another member state, outbound dividends are exempt as long as the requirements provided by the domestic implementation of the Parent-Subsidiary Directive are fulfilled, the most relevant of which being that the parent company must have a direct holding of at least 15%.

7. <u>Prohibition of Extra-Territorial Taxation of Dividends (Article 10, Paragraph 5)</u>

The general rule is that extra-territorial taxation of dividends is not permitted (i.e. State A cannot tax the distributed profits of a company resident in State B where B's (as a non-resident of State A) profits are derived in State A and are distributed to a resident of another state (i.e. not State B). In other words, Article 10(5) prevents State A from taxing dividends unless the payer or the payee is resident in State B that is where the (deemed) recipient is resident in a third state. Furthermore, State A may not tax State B company's undistributed profits even if the dividends paid or undistributed profits consist wholly/partly of profits or income arising in such other state (State A). Consequently, the taxation by State A of the undistributed profits of a State B resident company is prevented.

There are however two exceptions to the above contemplated by Article 10(5):

Part 1
State A may tax the dividends of State B Company to the extent the dividends are paid to a State A resident.

Part 2

State A may tax the dividends of State B Company to the extent that the holding in respect of which the dividends are paid is effectively connected with a PE in State A.

"Extra-territoriality" applies when a state tries to tax a dividend on the basis that the source of its profits, or part of the source of its profits, arises in that state even though the dividend does not emanate from a company resident in that state. This is strictly prohibited under the terms of a treaty. A state may, however, tax dividends from shares of companies, wherever resident, if the shares are effectively connected with a PE there.

8. Interplay of Article 10 and Article 5

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

Paragraph 1 of the relevant Articles of both the Models for taxation of dividend allots the primary right of taxation to the Residence-State of the beneficial owner of income ('may be taxed in the Residence State'). Paragraph 2, however, provides that such income 'may also be taxed in the Contracting State in which it arises and according to the laws of that State' on gross basis, not exceeding a stipulated limit.

There is, however, a common exception to the above rule in the Article 10 dealing with dividend income. This is popularly known as 'permanent establishment proviso'. If this proviso is applicable, the Residence-State loses its right of taxation and the income is fully taxable in the Source-State. The proviso runs in near-identical language in all the above articles in OECD and UN Model Convention (with minor differences), as under:

"The provisions of paragraphs 1 and 2 shall not apply, if the beneficial owner of the dividends, being a resident of a Contracting State, in which the company paying the dividend is a resident, through a permanent establishment situated therein or performs independent personal services from a fixed base situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 or 14, as the case may be, shall apply."

The India-US DTAA, however, following US Model, uses the term "attributable to" in place of " effectively connected with". The interpretation of the term "attributable to" in this paragraph is most likely to proceed on the same lines as in Paragraph 5 of Article 7 relating to taxation of profits of a permanent establishment, meaning ' profits derived from the assets and activities of the permanent establishment'. The OECD Commentary on Model Convention also proceeds on similar lines to state:

“Paragraph 3 is not based on a conception which is sometimes referred to as “the force of attraction of the permanent establishment”. It does not stipulate that royalties arising to a resident of a Contracting State from a source situated in the other State must, by kind of a legal presumption, or fiction even, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that in the State of source the dividends are taxable as part of the profits of the permanent establishment, there owned by the beneficiary, which is a resident of the other State, if they are paid in respect of shares, debt claims or right or property forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, the paragraph relieves the State of source of the dividends from any limitations under the Article. The foregoing explanations accord with those in the Commentary on Article 7.”

It has to be appreciated that the provisions of Paragraph 1 of Article 10 presupposes that the shares are owned and held by the non-resident. The State of source is granted a limited and secondary right of taxation because of passive income generated from the asset arises in the said country. In such taxation it is not possible to resort to net income taxation, as in the case of a permanent establishment, because the asset has been acquired and held abroad and it is not possible to identify the expenses incurred in connection with acquisition and exploitation of the assets. Hence, a presumptive taxation is done at a stipulated percentage of the gross income. However where the asset is owned by the permanent establishment in the State of source, and it has been acquired and exploited in the State of source by the permanent establishment so that the income is solely attributable to the permanent establishment, it will be only proper to follow Article 7(1) and tax such income in the State of source on net basis, as a part of the income attributable to the permanent establishment. In such a case, there will be no difficulty in computation of net income as all expenses as well as all incomes arise in the State of source. The terms ‘effectively connected' and ‘attributable' are synonymous. Only when the assets giving rise to incomes in the form of dividend are effectively connected or belong to the permanent establishment, the said incomes can be said to be attributable to the permanent establishment. It will defeat the purpose of the provisions if it is claimed that the assets are effectively connected with the permanent establishment but the income from the said assets are not attributable to the permanent establishment. Apart from being owned by the permanent establishment, the only example of being “otherwise effectively connected”, which comes to mind is a case of lease or assignment of shares to the permanent establishment, i.e., when the permanent establishment has an economic ownership to exploit the assets.

A.A.R in Advance Ruling P. No. 13 of 1995, In re - (2002-TII-04-ARA-INTL) explained the meaning of the term ‘effectively connected' as follows:

“All the outside activities are directed towards the installation of the manufacturing plant and industrial complex in India. Though carried out elsewhere, they are integrally connected with the project in India. The designs, basic engineering services and other services are based on information collected in India and the use of the process and technologies have to be adapted to the needs of, and prove workable in, Indian conditions. The permanent establishment in India has an undoubted voice over the outside activities as well and the royalties and fees for technical services cannot but be described as effectively connected with it." A.A.R, while holding that the activity of design, basic engineering services and other services carried out abroad, in connection with the contract of supply of manufacturing plant to India from abroad and installation, erection and commissioning of the plant in India was effectively connected with the activity of the permanent establishment in India, namely installation, erection, commissioning of the plant in India, was of the opinion that the fees for technical services receivable for design, basic engineering services and other related services would not be assessable under Article 12 but under Article 7. But on the issue of assessability of such income under Article 7, A.A.R took a contrary view holding that since the activities of preparation of design, basic engineering services etc. were carried out abroad, the income from such services cannot be said to be attributable to the permanent establishment. In the result, the income escaped taxation altogether in the Source State. The above decision of the A.A.R seems to be self-defeating in purpose.

There is another aspect of the matter. A bare reading of the 'permanent establishment proviso' in OECD and UN Model Convention and also the treaties entered into by India indicates a literal meaning that the beneficial owner of dividend etc. income should otherwise carry on business or perform independent personal services through a permanent establishment or fixed base in the Source-State and dividend or interest income must arise from assets owned or held by the permanent establishment etc., i.e., dividend yielding shares or debt-claims yielding interest. Similarly the income from royalties must arise from the rights or properties (intellectual properties) owned by the permanent establishment or fixed base.

9. <u>Special Rule for Undistributed Dividends of a CFC</u>

Most countries have Controlled Foreign Corporation (CFC) laws that enable authorities to levy such taxes. These laws effectively check the governments' revenue loss due to the transfer of undistributed dividends to offshore tax havens like Isle of Man, Cayman Islands and Mauritius. Indian tax authorities, for long, have maintained that there is a need to have a similar law here.

Tax experts say it will be difficult for the government to refrain from introducing such legislation as there is a substantial flow of outbound investments from India. "We should tax the undistributed dividend of the foreign corporations owned by Indian companies. It does not matter if the dividends are brought to India or not. Tax for this has to be paid here since the resources for making these cross-border acquisitions are mobilised from India," said a senior I-T department official, who asked not to be named.

PwC taxation leader Dinesh Kanabar said it was important that the introduction of CFC be preceded by a major change in the I-T Act that would allow consolidation of separate legal entities. "A company that exists in a foreign country could be controlled by an Indian company. It still, however, remains a separate legal entity. To treat both of them as a single legal entity requires a major change in the Income-tax Act." Today, besides the UK and US, CFC laws are present in 25 countries. Most have guidelines for defining CFCs. In the US, 50% of the voting rights or 50% of the value of shares is an indication of CFC. In some countries, CFC laws cover even the Permanent Establishments (PEs) of resident companies.

Cross-border taxation specialist TP Ostwal said it is still too early for India to introduce CFC laws. "CFC laws are introduced by developed countries whose outbound investments have substantially exceeded inward flow of funds for long. India has not got to that point," he added.

Incidentally, the major reason for the rising pressure on the government for CFC rules is the change in the investment pattern that shows outbound investments increasing at a steady pace in recent years. Across the world, the objective of introducing CFC laws is to curtail the loss of revenue. In line with that, tax is levied on the resident company irrespective of whether the dividend of its overseas company is distributed or not.

Test Your Knowledge

QUESTIONS	
1.	Explain the concept of ‘Paid’ as defined in Income-tax Act, 1961.
2.	Mr. Ram is resident of India and receives dividend income from Rama Ltd. which is resident company in USA. State whether such dividend will be taxed by USA government or not with reasons.

SOLUTIONS	
1.	As per Section 42(2) of Income-tax Act, 1961, ‘paid’ means actually paid or incurred according to method of accounting. ITAT observed that the term ‘paid’ has not been defined in the treaty, hence, it should be assigned domestic law meaning under Article 3(2) of the treaty. The term ‘paid’ is defined under section 43(2) to mean “actually paid or incurred according to the method of accounting.". All the coordinate bench decisions on this issue and also Bombay HC decision in case of DIT vs. Siemens AG are rendered without considering Article 3(2) & Section 43(2) and could possibly be per incuriam. ITAT referred to Standard Triumph Motor Co. Ltd. [1993] 201 ITR 391 wherein the SC held that the credit entry in the assessee's books does amount to receipt for the recipient in UK. ITAT felt that it is indeed worth exploring as to whether the meaning assigned to the expression “received by an assessee”, which essentially corresponds to and has to treated as equivalent to “paid to the payee", by SC in Standard Triumph is to be assigned to the treaty of the undefined treaty expression "paid". ITAT noted that this aspect remained unexamined in co-ordinate bench and Bombay HC decisions. Recommendation has been made for constitution of a special bench. ITAT noted that in the event of a doubt about the correctness of the earlier decision or, extending that logic a little further, correctness of the path the earlier decisions have traversed to come to a conclusion, it is open to the bench to make a reference to for constituting a larger bench for considering the same.
2.	The general rule is that extra-territorial taxation of dividends is not permitted (i.e. State A cannot tax the distributed profits of a company resident in State B where B’s (as a non-resident of State A) profits are derived in State A and are distributed to a resident of another state (i.e. not State B). In other words, Article 10(5) prevents State A from taxing dividends unless the payer or the payee is resident in State B that is where the (deemed) recipient is resident in a third state. Furthermore, State A may not tax State B company’s undistributed profits even if the dividends paid or undistributed profits consist wholly/partly of profits or income arising in such other state (State A). Consequently, the taxation by State A of the undistributed profits of a State B resident company is prevented. Therefore, such dividend received by Mr. Ram will not be taxable in USA as he is a resident of India.

Income from Equity and Debt Investment

Module II – Interest

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9.	Arm's Length Rule for Interest (Article 11, Paragraph 6)
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10. Introduction

Interest income is earned from deposits in the form of fixed deposits, recurring deposits, etc. As per Income-tax Act, 1961 interest income is usually taxable under the head “Income from other sources”. Different countries tax the interest income in different manner. It becomes pertinent to understand how interest is to be taxed as per Article 11.

11. Scope and Accrual of Interest

Interest income is the amount earned from different financial products, accounts and investments. It can be earned when money is lent to another entity, depositing funds with a bank or a financial institution, or even investing money in certain schemes. Interest income is typically paid out at a specified rate of interest. In other words, it is generally guaranteed. Another key feature of interest income is that it is most often paid out periodically. So, a person can earn interest on a monthly, quarterly, semi-annual or annual basis. Irrespective of the rate of interest and the frequency of payout, assessee needs to pay income tax on the interest earned from different financial products. To understand how this works, the financial products that offer interest income are to be understood.

There are different ways to earn interest income, some of these are as follows:

(i) Savings Accounts

A savings account is one of the most fundamental financial products. And this is the most basic kind of interest income that individuals can earn. The money that is deposited in the savings bank account slowly accumulates interest at a specified rate over the months. At the end of the financial year, the interest earned will be liable to be taxed as per the provisions of the Income Tax Act.

(ii) Fixed Deposits (FDs)

A fixed deposit or a term deposit is a kind of financial product that allows assessee to earn compound interest at competitive rates. The assessee can deposit large sums of money in FD account and earn interest at the rates specified. This interest can be reinvested in fixed deposit over the specified tenure, as in the case of cumulative FDs. Alternatively, assessee can also opt to have the interest paid out to him. In this case, periodic income on a monthly, quarterly, semi-annual or annual basis can be earned. Irrespective of whether the interest is paid out or reinvested, assessee must pay income tax on the interest earned.

(iii) Recurring Deposits (RDs)

Recurring deposits allows depositing a fixed sum of money in RD account periodically. At the end of the specified tenure, the total amount that has been deposited is paid out along with the interest thereon. This interest income too is subject to taxation.

(iv) Government and Corporate Bonds

Bonds issued by government entities and corporate entities are both preferred investment options. These bonds are typically long-term assets, and they pay out interest at the coupon rate specified on the bonds. The interest may be paid out periodically, or it may be paid out at the time of redemption of the bond.

(v) Public Provident Fund (PPF)

The Public Provident Fund is one of the most popular tax-saving investments in India. It has a tenure of 15 years. And the amount that is deposited into the PPF account each year earns interest at the rate specified by the government of India. Currently, the rate of interest on PPF investments is 7.1% per annum.

The manner in which interest income earned from above products is taxed is described below.

(i) Tax on Savings Account Interest

The interest earned on the savings account is taxed as other income. However, assessee can make use of certain provisions of the Income Tax Act to save tax. If a person is not a senior citizen, he can claim a deduction up to Rs. 10,000 under section 80TTA under Income Tax Act, 1961. This limit includes the interest income from all the savings bank accounts an assessee owns and operates.

On the other hand, if a person is a senior citizen, he can claim a deduction up to Rs. 50,000 under section 80TTB.

(ii) Tax on interest from Fixed Deposits and Recurring Deposits

An assessee needs to pay income tax on interest earned from fixed deposits and recurring deposits. This income is also taxed as income from other sources, at the income tax slab rate applicable.

However, when an assessee opts for FD interest payouts, most banks typically deduct TDS at 10% if the interest income is Rs. 40,000 or higher. For senior citizens, the limit is Rs. 50,000 or higher. If an assessee does not have a PAN, the TDS rate is 20%.

But if the total income from all sources is below the basic exemption limit, an assessee can avail an exemption from the tax deduction. To do this, one must file a self-declaration form (15G for non-seniors and 15H for seniors).

(iii) Tax on Interest from Bonds

In the case of corporate bonds, the interest income is taxed as income from other sources. However, if assessee has invested in tax-free government bonds, there is no need to pay income tax on interest income. This is because the interest is tax-free as per section 10(15)(iv)(h) of the Income-tax Act, 1961.

(iv) Tax on Interest from PPF

The Public Provident Scheme (PPF) is an exempt-exempt-exempt investment option. This means that the amount invested, the withdrawal amount and the interest earned are all tax-free. So, assessee need not pay any tax on the interest income from PPF.

12. <u>Allocation Rule for Interest (Article 11, Paragraph 1)</u>

Paragraph 1 of Article 11 lays down the principle that interest arising in a Contracting State (say country S) and paid to a resident of the other Contracting State (say Country R) may be taxed in that other state (i.e. in country R). OECD commentary gives no exclusive right of taxation of interest either to country R or country S. Article 11(5) provides that interest is deemed to arise in the Contracting State if "payer" is resident of that Contracting state. As per exception to the above rule, if the payer of interest has PE in a contracting state; and the interest is actually borne by a PE of the payer in that Contracting State; then such contracting state has right to tax the interest borne by such PE.

13. <u>Interest 'Paid'</u>

Interest is the charge a person is required to pay on the money borrowed. Interest is payable on debentures and bonds and other debt securities or monies borrowed.

Interest may be paid as simple interest or as compound interest. Simple interest is paid at a fixed rate per annum. Compounding allows for the calculation of interest on the principal and the accumulated interest.

As per Section 2(28A) of Income-tax Act, 1961, unless the context otherwise requires, the term "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised.

14. <u>Scope of Article 11</u>

Paragraph 3 of Article 11 provides that the term "interest" means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this article.

15. <u>Withholding Tax Clause (Article 11, Paragraph 2)</u>

Paragraph 2 of Article lays down that interest may also be taxed in the Contracting State in which it arises and according to the laws of that State (i.e. Country S), but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed:
(a) XX% 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) XX% of the gross amount of the interest in all other cases.

16. <u>Force of Attraction on Outbound Interest Effectively Connected to a PE (Article 11, Paragraph 4)</u>

Provisions of Paragraph 1 and 2 of Article 11 not to apply when

- Beneficial owner of Interest
  (i) Carries on business in Source country
  (ii) Through Permanent Establishment (PE) / Fixed Based and

- Debt claim in respect of which interest is paid is 'effectively connected' with –
  (i) The Permanent Establishment or fixed base
  (ii) Business activities referred to in Article 7 (1) (c)

In case of **Merubeni Corporation (Japan)**, the Assessee is a company incorporated in Japan, having various streams of income like business income from PE in India, income earned as fees from technical services, income from shipping business and income from interest on suppliers' credit etc. The interest income received by the Assessee from its customers on supplier credit by reason of sale of goods (manufactured by other company) by the Assessee or one of its controlled entities. This income was offered to tax @ 10% as per Article 11(2) of Indo-Japanese DTAA. However, assessing officer (AO) noted that Assessee has a PE in India therefore, lower rate of 10% is not applicable on interest income as per Article 11(6) of Indo-Japanese DTAA and the same should be taxed at 40% as per Article 7 of DTAA. AO's view was challenged by the Assessee before Ld. CIT(A) and Ld. CIT(A) upheld that the interest income in question is required to be taxed @ 10% in terms of the provisions of the Article 11(2) of DTAA as there is no connection between the interest income and the permanent establishment.

Hence this appeal before ITAT by AO:
(i) Whether interest income is taxable as per Article 11(2) of DTAA knowing the fact that Assessee has a Permanent Establishment in India?
(ii) Whether interest income was not "effectively connected" with the PE in India knowing the fact that the interest income on loans in the form of supplier's credit

given to those Indian parties who were also the clients of the Assessee in India with whom contracts were executed through the Permanent Establishment.

Hence ITAT Held:

(i) As per Article 11(2) of DTAA, interest may also be taxed in the Contracting State in which it arises, and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

(ii) However, as per Article 11(6) of DTAA, the provisions of Article 11(2) will not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein and the interest is "effectively connected" with such permanent establishment. In such a case, provisions of Article 7 of DTAA shall apply.

(iii) As per Article 7(1) of DTAA, the profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. And such income is directly or indirectly attributable to that permanent establishment.

(iv) "Attribution of an income to the permanent establishment" is a degree higher than mere "Connection of an income with the permanent establishment". While every income attributable to a permanent establishment inherently has a connection with that permanent establishment, the converse is not necessarily and universally correct, as there can be incomes which may have some connection with the permanent establishment and yet the connection may not be material enough to hold that such an income is attributable to that permanent establishment.

(v) Article 11(6) does not explicitly provide for taxation of interest income at a rate higher, it only provides a situation in which the interest is "effectively connected" with a PE or a fixed base, the provision of Article 7 will come into play. Hence, unless the taxability under Article 7(1) comes into play, the exclusion clause under Article 11(6) is meaningless.

(vi) An interpretation of Article 11(6) to make the exclusion clause under article 11(6) meaningless will result in an interpretation contrary to the well-settled principle of interpretation "ut res magis valeat quam pereat", i.e., to make a legal provision workable rather than redundant.

(vii) The scheme of Article 11(6) does not visualize a situation in which the source jurisdiction taxability of an interest income under Article 11(2) will be ousted because of the enterprise having a permanent establishment in the source jurisdiction, and such an interest income will also not be taxable under article 7(1) as the interest income is not attributable to the permanent establishment.

(viii) Therefore, the connotations of the expression "Effectively Connected", in respect of Article 11(6) read with Article 7(1), must be such that unless the interest income cannot be held to "directly or indirectly attributable to a PE", the taxation of such an interest income, at a rate higher than article 11(2), does not come into play.

(ix) In conclusion of the above discussion, an interest income can only say to be effectively connected with a permanent establishment only when such connection leads to taxability in the hands of the taxpayer under Article 7(1).
(x) Unless that taxability comes into play, there cannot be any overlapping in the scope of article 11 visà-vis Article 7 and, unless there is such an overlapping of the treaty provisions, there is no occasion for exclusion of one of the overlapping treaty provisions by Article 11(6).
(xi) Hence, the taxability under Article 7 is a "Sine Qua Non" for triggering the exclusion clause under Article 11(6)
(xii) Since AO had already indicated that the Assessee had a PE in India and there was presumably some connection between the interest income of the Assessee and the existence of the PE however, AO failed to provide any conclusive evidence as to whether such interest income is effectively connected with the PE in India.
(xiii) Therefore, even if the interest income is connected with the Assessee company's PE, it can only be brought to tax in India, under Article 7 of DTAA (at a higher rate), when the interest income is directly or indirectly attributable to that PE and hence decision of Ld. CIT(A) was upheld.

17. <u>Interest Effectively Connected to, and Borne by, a PE (Article 11, Paragraph 5)</u>

Paragraph 5 of Article 11 provides for extra-territorial taxation of interest. It states that, "Interest shall be deemed to arise in a contracting state when the payer is a resident of that state. Where, however, the person paying the interest, whether he is a resident of a contracting state or not, has in a contracting state a permanent establishment in connection with which the indebtedness on which the Interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the state in which the permanent establishment is situated."

For example: There is a UK Co. which has taken loan from a US Co. The UK Co. has a branch (which constitutes PE) in India. The loan taken from US Co. is for the branch in India. Interest is paid by the UK Co. to the US Co. which is ultimately borne by the branch in India. Therefore, in such a case, the interest arises in the state in which the PE is located i.e. India. It can be observed that:

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

18. <u>Arm's Length Rule for Interest (Article 11, Paragraph 6)</u>

Paragraph 6 of Article 11 provides for Arm's Length Condition. The rule given in paragraph 6 will operate where a special relationship prevails between the payer of interest and beneficial owner of the interest and the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. Therefore, benefit of Article 11 for lower tax rates applies only to the arm's length interest. Here, special relationship means i) participation in management, control or capital (direct or indirect) and ii) relatives (relationship by blood or marriage).

For example, a subsidiary company in India pays interest @ 15% to the holding company in USA but interest @ 10% to another unrelated company in USA, the excess of 5% would be required to be scrutinized. The exact nature of excess amount has to be determined in order to categorize such income as dividend or other income under the domestic laws. Possibly Article 7, 10 or 21 of the relevant tax treaty may apply.

19. <u>Sec. 9(1)(v) under the Income-tax Act, 1961</u>

As per section 9(1) (v) of Income-tax Act, 1961, interest payable to the non-resident could be from the following payers:

- ✓ Interest payable by Indian Government
- ✓ Interest payable by a Indian resident to non-resident
- ✓ Interest payable by one non-resident to another non-resident

Under section 9(1)(v), interest payable by any person who is a resident in India, to a non-resident, shall be deemed to accrue or arise in India, unless it falls under the following two exceptions:

(i) Interest is payable for money borrowed and used for the purposes of a business or profession carried on by person outside India; or
(ii) Interest is payable for earning any income from any source outside India.

However, one should note, that where money has been borrowed for any of the two above purposes, but is actually used in a business or profession in India or earning income in India, it shall be deemed to accrue or arise in India in the hands of the non-resident.

Interest payable by one non-resident to another non-resident, shall be deemed to accrue or arise in India if such interest is payable, in respect of any debt incurred or moneys borrowed and used for the purpose of a business or profession carried on by such non-resident in India. Interest on money borrowed by the non-resident for any purpose other than for business or profession, will not be deemed to accrue or arise in India.

Prior to the amendment carried out by Finance Act 2015, while the interest payments were considered as a deductible expenditure in the hands of the Indian branch, such receipts were considered as non taxable in the hands of the head office, on the ground that these payments constituted as payments to self which were not liable to taxation.

Finance Act 2015, made certain amendments, whereby interest payable by Indian PE of foreign bank, would be deemed to accrue or arise in India if recipient is:

(i) Head office of bank located outside India; or
(ii) PE of bank located outside India; or
(iii) Any other branch outside India.

20. <u>Withholding Tax under Sec. 194LC</u>

With effect from 1st July 2012, section 194LC was incorporated into the Income-tax Act, 1961. The section deals with TDS deduction on income by way of interest from an Indian Company or a business trust and the provisions relating to the same has been explained in the current article.

The basic provisions of section 194LC are narrated hereunder –

(i) The Indian Company or a business trust paying interest income to a non-resident, not being a company, or to a foreign company is liable to deduct TDS.
(ii) Interest income payable by the Indian Company or the business trust on the following is covered under section 194LC.

- Interest in respect of money borrowed by the Indian Company or the business trust in foreign currency from a source outside India.

a) Under a loan agreement between 1st July 2012 to 1st July 2020.
b) By issuing long term infrastructure bonds between 1st July 2012 to 1st October 2014.
c) By issuing long term bond including long term infrastructure bonds between 1st October 2014 to 1st July 2020.

- Interest in respect of money borrowed by the Indian Company or the business trust in foreign currency from a source outside India by way of issue of rupee denominated bond before 1st July 2020.

- To the extent, the interest income does not exceed the amount of interest calculated at the rate approved by the Central Government.

The Deductor is liable to deduct TDS within earlier of the below mentioned dates –

– At the time of payment thereof in cheque or cash or draft or any other mode of payment; or
– At the time of credit of interest income to the account of the payee.

The Deductor is liable to deduct TDS @ 5%. In addition to the same, the Health and Education Cess is to be added to the base rate. Further, if the Surcharge gets applicable the same is also to be added.

Test Your Knowledge

QUESTIONS	
1.	XYZ India has entered into an agreement with a Mauritius company for importing raw material. In order to make payment for such imports, it avails buyer's credit from ABC bank, located in Mauritius. Whether interest payment made by Indian Co. to ABC bank under buyer's credit would be considered as income which is deemed to accrue or arise in India?
2.	Non-resident 'X', engaged in manufacture of computer software, borrows money from another non-resident 'Y', and invests the same in shares of an Indian company for investment purposes. Whether interest payable by 'X' to 'Y' would be deemed to accrue or arise in India?

SOLUTIONS	
1.	Interest payment made by a person who is a resident in India, would be deemed to accrue or arise in India, where money is borrowed for the purpose of business or profession carried on by such resident in India. In this case, interest on buyer's credit, is paid by Indian Co. for the purpose of its business in India. Thus, such interest income would be deemed to accrue or arise in India.
2.	Interest on money borrowed by a non-resident, for any purpose other than a business or profession, will not be deemed to accrue or arise in India. In this case, money was borrowed for the purpose of investment and not for the purpose of business or profession of non-resident X. Thus, interest payable by X would be deemed to accrue or arise outside India.