History of International Tax Treaty

Scope, Structure and Purposes of Tax treaties

NALSAR University of Law, M.A. (International Taxation)

4 December 2021

Speaker

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Importance of International Treaties

Economic Interaction

Flow of capital and resources

Smooth and effective implementation of law and order

Increasing interactions between countries and people

Need for common agreement amongst countries

Some types of International Treaties

01

Extradition Treaties

Agreement amongst countries in relation to extradition of a person to another country

02

Investment Promotion and Protection Agreements

For the promotion and protection of investments made by investors of one country in the area of the other country

03

Trade Agreements

Set out the rules governing trade amongst countries

04

International Solar Alliance

Treaty based inter-governmental organisation to work for efficient consumption of solar energy to reduce dependence on fossil fuels

05

Outer Space Treaty

Formally, the *Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, including the Moon and Other Celestial Bodies* – a treaty that forms the basis of international space law

Vienna Convention on Law of Treaties (1969)

1. VCLT – an international agreement regulating treaties between countries
2. “Treaty on treaties“ – establishes comprehensive rules, procedures, and guidelines for how treaties are defined, drafted, amended, interpreted, and generally operated
3. Codification of customary international law and practices concerning treaties
4. One of the most important instruments in treaty law till date and remains an authoritative guide in disputes over treaty interpretation
5. Even though India isn't a party to the VCLT, Indian courts have applied VCLT principles while interpreting tax laws
6. Key aspects based on the Preamble of VCLT:
   - » Recognises the importance of treaties as a source of international law + as a means of developing peaceful cooperation & friendly relations among nations, maintenance of international peace and security
   - » Acknowledges that disputes concerning treaties, like other international disputes, should be settled by peaceful means and in conformity with the principles of justice and international law
   - » Bears in mind principles of international law embodied in the Charter of the United Nations (e.g. equal rights, equality, human rights etc.)

Important Articles of VCLT

Article 26

'Pacta sunt servanda'

Every treaty in force is binding upon the parties to it and must be performed by them in **good faith**.

Article 27

'Internal law and observance of treaties'

A treaty party may not invoke the provisions of its internal law as justification for its failure to perform a treaty

Article 31

'General rule of interpretation'

A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their **context** and in the light of its **object and purpose**.

Article 32

'Supplementary means of interpretation'

In the interpretation of a treaty, recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31

Section 90 of Indian Income Tax Act, 1961

- Empowers Central Government to enter into tax treaties with other countries
- Peephole to tax treaties
- To do a deep dive into Indian tax treaties, this section must be analysed in-depth first
- Indian government can enter into tax treaties with other countries for the following reasons:

1. **Relief Treaties:**

- For the granting of relief in respect of—
  - income on which have been paid both income-tax under Indian Income-tax Act and income-tax in the other country, or
  - income-tax chargeable under Indian Income-tax Act and under the corresponding law in force in that country, **to promote mutual economic relations, trade and investment**

Section 90 of Indian Income Tax Act, 1961

2. **DTAA: Double Tax Avoidance Agreement**

- For the avoidance of double taxation of income under Indian Income-tax Act and under the corresponding law in force in the other, **without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory**)

3. **EOI: Exchange of Information**

- For the prevention of evasion or avoidance of income-tax chargeable under Indian Income-tax Act or under the corresponding law in force in the other country, or investigation of cases of such evasion or avoidance. In tax parlance, they are often regarded as Tax Information Exchange Agreements

4. **Recovery of income-tax under Indian Income-tax Act and under the corresponding law in force in the other country**

Give and Take Formula for Tax Treaties

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- Tightrope walk by countries and governments: Needs of incoming foreign capital to be balanced with the bouquet of offerings for foreign investors
- To attract foreign investors, countries are inclined to demonstrate how their jurisdiction is relatively better placed than other jurisdictions in terms of tax framework, such as:
  - Lower regime of taxation for foreign capital or foreign IPRs
  - Stability and certainty in taxation regime
- Tax treaty language should be understood from the perspective of governments as tax treaty negotiators are not necessarily international tax professionals or tax consultants or advisors

Model Tax Conventions

1. Two world level model tax conventions in place:
   - » OECD Model Convention
   - » UN Model Convention

2. Countries like USA have their own model conventions also. OECD Model Convention generally viewed as in favour of the developed economies and the UN Model Convention generally viewed as favouring the lesser-developed economies or the developing economies

3. Long history of evolution behind these model conventions → Their importance as an interpretational tool cannot be ignored. For the purpose of our session, let's keep the OECD Model Convention as the reference point

Evolution and History of International Tax Treaty Framework

1. League of Nations (1920s)
2. League of Nations' Model Treaty (1928)
3. Meeting in Mexico (1945) and London (1946) – starting point by OEEC and OECD
4. Fiscal Committee work (1956 onwards)
5. 4 Interim Reports: 1958 to 1961
   Final Draft: 1963
6. Revisions to Draft Convention: 1963 to 1977
7. Adoption of 'Ambulatory' Model Convention: 1991
8. Publication of Model Convention in loose-leaf format: 1992
9. Addition of non-member nations' positions 2nd volume (including India)
10. Since 1st revision in 1992, Model Convention has been updated 10 times. Last update in 2017: BEPS and Action Plans

Relevance of OECD Model Convention

- Largely conformed to by OECD Members
- Used as a basic document of reference in negotiations between member and non-member countries and even between non-member countries
- Commentaries on the provisions of Model Convention have become a widely accepted guide to the interpretation and application of existing bilateral tax treaties

Objectives of Tax Treaties

- Provides for the tax claims of two governments both legitimately interested in taxing a particular source of income: Either assigns the whole claim to one of the two OR else prescribes the basis on which tax claim is to be shared between them.
- Avoidance of double taxation + prevention of fiscal evasion + non-discrimination + exchange of information

Determining which of the two countries may subject the income to their taxes

- Sometimes the right to tax is given to the source country (i.e. where income arises), exclusively or by way of priority
- In other cases, the residence country of the income recipient has the exclusive right to tax;
- While in some other cases, taxing right is shared between the source country and residence country may tax the income → in such case, the source country limits its tax to a certain minimum whereas the residence country reduces its own tax on the same income according to the methods specified in the concerned tax treaty

Method of allocating taxation

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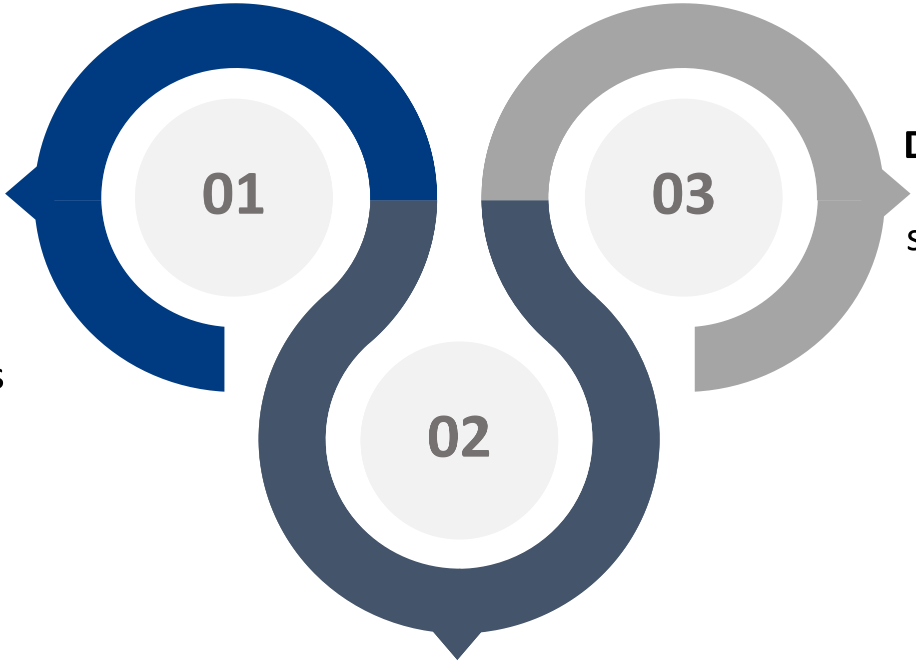
This will depend upon the nature of income. For instance,



Income from business is taxed only in the resident's country, if the business undertaking carries on no activity in the source state. But, if there is a fixed place of business, i.e. 'Permanent Establishment', then, the business profits will be taxed in the source country

Income from immovable property arising to a non-resident is taxed primarily in the country of immovable property's location

Dividend, interest or royalty are primarily taxed in the residence country, but the source country may impose a reduced tax

Policy adopted by the Indian government in relation to tax treaties

Indian Tax Treaties

- To promote economic and industrial development
- Coordination of Indian taxation with foreign tax legislation for Indian as well as foreign companies trading with India
- Tax treaties are intended to permit the Indian authorities to co-operate with the foreign tax administration
- Tax treaties are good compromise between ‘source country taxation’ and ‘residence country taxation’
- Tax revenues are sacrificed in exchange for the economic and industrial development of the country, so as to permit flow of technology in India. Temporary loss of revenue is tolerated in view of the long-term economic planning consideration

BEPS Project and MLI

- **BEPS**: '*Base Erosion and Profit Shifting*', **MLI**: '*Multilateral Convention to implement Tax Treaty related measures to prevent Base Erosion and Profit Shifting*'.
- What is BEPS? Increasing cross-border economic interactions → aggressive international tax planning strategies, e.g. if the tax rate in country B was only 5%, then, a tax resident of country A might have 'artificially shifted' its business profits to country B just to avail this tax benefit.
- Why is BEPS bad? Governments lost substantial corporate tax revenue as such aggressive international tax planning can lead to double non-taxation or reduced taxation.
- Digital economy has made the detection of aggressive international tax planning strategies even more hard to detect
- Pressuring issue not only for industrialized countries but also for emerging economies and developing countries.

BEPS Project and MLI

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- OECD / G20 BEPS Project – to mitigate tax code loopholes and country-to-country inconsistencies so that corporations cannot shift profits from a country with a high corporate tax rate to countries with a low tax rate.
- BEPS Package consists of 15 action plans agreed to by all participating countries who had committed to consistent implementation.
- Amongst other things, the BEPS Package included tax treaty-related measures to address certain hybrid mismatch arrangements, prevent treaty abuse, address artificial avoidance of permanent establishment status, and improve dispute resolution.
  - Implementing them through renegotiation of each and every bilateral tax treaty would have been cumbersome
  - Hence, MLI was executed to implement the agreed changes in a synchronized and efficient manner
  - MLI changes the application of existing bilateral tax treaties

TAX TREATY PROVISIONS

- Scope
- Definitions
- Distribution of Taxing Rights
- Limitation of Relief
- Avoidance of Double Taxation
- Special Provisions
- Other Articles

Scope of Tax Treaty

- Let us take India – Singapore tax treaty as a reference point for our discussion. Broadly, all Indian tax treaties will have similar structures.
- Preamble is very important. Preamble of India – Singapore tax treaty looks like this:

The Government of the Republic of India and the Government of the Republic of Singapore, desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income

> *The following preamble text described in paragraph 1 of Article 6 of the MLI is included in the preamble of the Agreement:*
>
> ***ARTICLE 6 OF THE MLI Purpose of a Covered Tax Agreement***
>
> *Intending to eliminate double taxation with respect to the taxes covered by this Agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in the Agreement for the indirect benefit of residents of third jurisdictions),*

- The portion in box is added pursuant to the MLI to emphasize that opportunities for non-taxation or reduced taxation are not a purpose of a tax treaty.

Article 1 - Personal Scope

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

- As per Article 1, the tax treaty applies to ‘residents’. Citizenship is immaterial.
- Why is it an important article? Defines the broad contours of the persons who will be covered within the scope of a tax treaty.
- Under the OECD Model Convention, Article 1 contains another paragraph with respect to fiscally transparent entities. However, India has reserved its right to not include that paragraph in its tax treaties.

Article 2 - Taxes Covered

1. *The taxes to which this Agreement shall apply are*:

    a) *In India: income Tax, including any surcharge thereon (hereinafter referred to as "Indian tax");*

    b) *In Singapore: the income tax (hereinafter referred to as "Singapore tax").*

2. *The Agreement shall also apply to any identical or substantially similar taxes which are imposed by either Contracting State after the date of signature of the present Agreement in addition to, or in place of, the taxes referred to in paragraph 1. The competent authorities of the Contracting States shall notify each other of any substantial changes which are made in their respective taxation laws*.

    - This Article makes the terminology and nomenclature relating to the taxes covered by the tax treaty more acceptable and precise; and ensures identification of the Contracting countries' taxes which covered by the tax treaty.

Article 2 - Taxes Covered

For example, the OECD Commentary states that Greece and Latvia hold the view that "taxes on the total amounts of wages or salaries paid by enterprises" should not be regarded as taxes on income and therefore will not be covered by the Convention.

- India's Equalisation Levy…not introduced as part of Indian Income-tax Act → Foreign enterprises cannot seek any relief under Indian tax treaties in relation to the applicability of this levy!

Definitions

Company	Any body-corporate or any entity which is treated as a company or body corporate under the taxation laws in force in the respective Contracting States
Country	Sometimes, the definition of a country also becomes important as in some cases, it becomes a research point as to whether a particular area falls within the ambit of a defined country under the tax treaty
Undefined Terms	Another critical element in the definitions article is in relation to undefined terms. As you can see below, Paragraph 2 of Article 3 states that any term not defined shall, **unless the context otherwise requires**, have the meaning which it has under the law of that country concerning the taxes to which the tax treaty applies. In fact, our Income-tax Act also contains a provision to state that where any term used in a tax treaty is not defined in the said tax treaty, but defined in the Income-tax Act, it shall have the same meaning as assigned to it in the Income-tax Act and explanation, if any, given to it by the Central Government

Definitions (contd.)

As regards the application of the Agreement by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of that State concerning the taxes to which the Agreement applies.

- ‘Static approach’ or ‘ambulatory approach’? Which legislation should be considered – whether the legislation in force when the tax treaty was signed or that in force when the tax treaty is being applied. OECD has taken the view that the latter interpretation should prevail.
- **Resident of a Contracting State**: To solve dual-residency conflicts. And these tie breaker rules move in a sequential manner. For instance

Permanent Home → Centre of Vital Interests → Habitual Abode → Nationality → Mutual Agreement

Definitions (contd.)

Permanent Establishment (PE):

- No PE = No tax → Business profits of a foreign enterprise cannot be taxed by source country unless it carries on its business through a PE situated therein.
- PE means a fixed place of business, through which the business of an enterprise is wholly or partly carried on. The article also includes certain types of locations specifically in the definition of PE, such as a branch, office, factory, workshop etc.
- *PE determination is a fact-based exercise and would also differ for each industry. Recent expansion of the digital economy has increased the level of complexity and difficulty even more in relation to determination of PE*

Key Definitions (contd.)

Types of PE:

- Fixed Place PE
- Construction PE
- Supervision PE
- Service PE
- Agency PE

- All these types of PEs need specific conditions to be fulfilled for a prescribed number of days. This threshold number of days would depend upon bilateral negotiations between treaty partners
- The PE article lists a number of business activities which are treated as exceptions to the general definition and which when carried on through fixed places of business, are not sufficient for these places to constitute permanent establishments.
- Preparatory and auxiliary character
- PE determination in multi-jurisdiction corporate structures
- India has expressed several reservations in relation to this article in the OECD Model Convention

Background

- Tax treaties never create a tax charge, the tax charge is created under the domestic tax laws of countries. Tax treaties merely provide a relief from taxation and contain the manner in which taxing rights over a particular stream of income or over a taxpayer will be distributed or allocated amongst the treaty partners.
- League of Nations in the 1920 — 'economic allegiance'
- Characteristics of the nature of distribution or allocation rules—depends upon the mutual economic and trade relations between each set of countries
- Helps determine which of the two countries may subject the income to their taxes:
  - Sometimes the right to tax is given to the source country, exclusively or by way of priority
  - In other cases, the residence country of the income recipient has the exclusive right to tax
  - In some other cases, taxing rights are shared between the source country and residence country : source country limits its tax to a certain minimum whereas the residence country reduces its own tax on the same income according to the methods specified in the concerned tax treaty

Immovable Property

Taxing right is given to the country in which the immovable property s situated

There is always a very close economic connection between the source of this income and the source country

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Business Profits

- Primary taxing right is given to the residence country
- Exception: If the non-resident's business in the source country is carried on through a PE. But only those business profits which are attributable to PE
- Specific over general: If the nature of income is such that some other article of the tax treaty deals with it separately, then the taxing rights will be determined in accordance with that other article (ALP is also relevant)

Operation of Ship/Air Transport & AE

Income from the operation of ships and air transport

- Profits derived by an enterprise of a country from the operation of ships or aircraft in international traffic shall be taxable only in that country (country of residence)
- In some treaties, the taxing right is given to the country in which the place of effective management (POEM) is situated

Associated Enterprises (AE)

- Refers to related parties under tax laws
- Deals with arm's length price (ALP) under transfer pricing regulations

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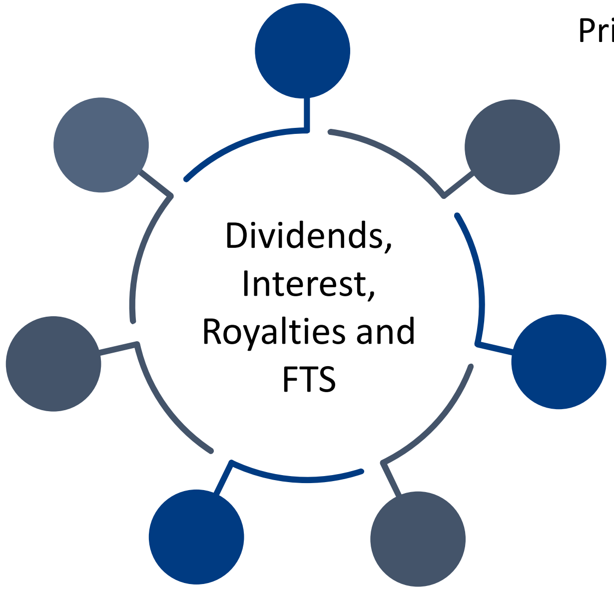
Distribution rules for dividends, interest, royalties and fees for technical services (FTS) are similar



Primary taxing right: Country of residence

Key rationale: In identifying the nexus of such income streams with either of the treaty countries, the contribution of the country of residence cannot be underestimated

Source country may also be given the 'right' to levy tax: Depends on domestic law e.g. dividends in Indian treaties

Lower rates are made dependent on certain qualifying conditions—e.g. depending upon fulfilment of a prescribed level of shareholding in case of dividend

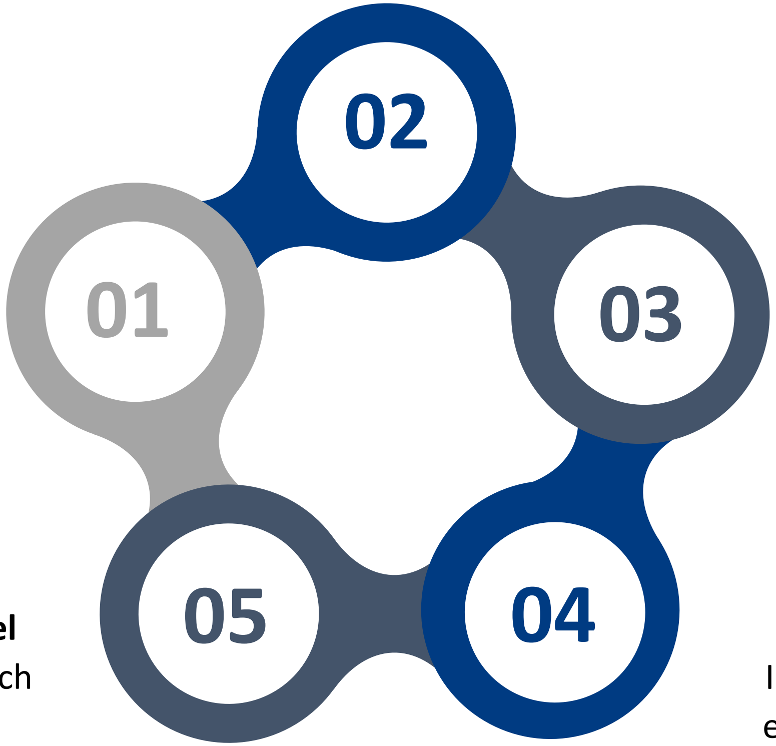
Extremely significant for foreign enterprises, multi-tier corporates and foreign investors

Certain key definitions for income streams—e.g. 'royalty' in Indian context

Capital Gains

1. Taxes on capital gains vary from country to country:
   - Taxed as Ordinary Income: added to the income from other sources; or
   - Subject to Special Taxes: alienation of property, capital appreciation, general capital gains tax
2. The above aspects are dealt with under domestic law and not under tax treaties
3. Capital gains earned from the transfer of an immovable property: taxed in country where property is located
4. Capital gains on shares: subject to contests (India-Mauritius and India-Singapore tax treaties)
5. India’s 2017 amendment—grandfathering effect

Independent Personal Services



Classifies the income of certain specified professionals into a separate category

Primary taxing right on professional income: Country of residence of professional

Certain exceptions: Income shall be taxable in source 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

Deleted in 2000 from OECD Model Convention: OECD's view is that such income is now dealt with under Article 7 as business profits only

Dependent Personal Services

- Deals with income from employment
- Includes salaries, wages and other similar remuneration and other employment benefits (stock options, insurance, memberships etc.)
- Primary taxing right: Country of residence UNLESS employment is actually undertaken from source country
- Additional condition to be fulfilled for taxing right of source country: Recipient's presence in source country should cross a prescribed number of days threshold
- India v OECD:
  - While the OECD Model Convention prescribes a 183-day threshold for the purpose of determining taxing right of source country, India has reserved the right to decide the period of stay referred in this article through bilateral negotiations
  - Remuneration received by a person for an obligation not to work for a competitor of his ex-employer

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Income Streams

1. **Directors' fees**
   Taxable in the source country i.e. country where the concerned company resides

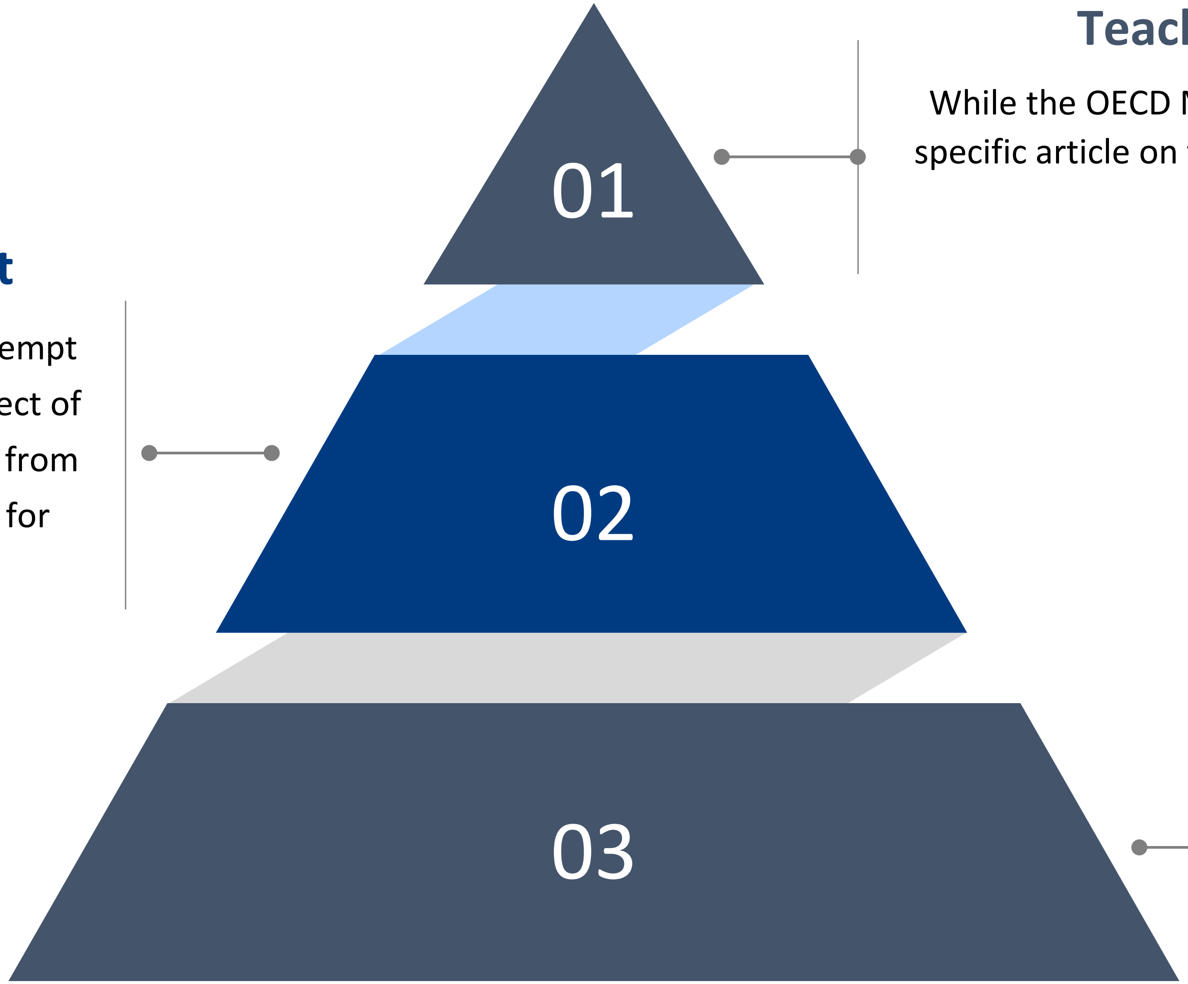
2. **Artists and sportspersons**
   May be taxed in the country in which their 'personal activities' as such are performed + Understanding difference in interpretation by India and OECD

3. **Salaries, wages, etc. in respect of government service**
   Usually, exclusive taxing power is given to the paying country. It is important to note that if the services are performed in connection with business carried on by the country, or one of its political subdivisions or local authorities, paying the remuneration, then, this article will not apply

4. **Non-government pensions and annuities**
   Pensions paid in respect of private employment are taxable only in the country of residence of the recipient

5. **Students and trainees**
   Certain payments received by students or trainees for the purpose of their maintenance, education or training received from sources outside the country in which the student or trainee concerned is staying shall be exempted from tax in that country

Income Streams



Teachers and researchers

While the OECD Model Convention does not contain any specific article on this, India has reserved a right to include this article

Income of government

Government of a country shall be exempt from tax in the other country in respect of income derived by that Government from sources within the other country – for instance, dividends, interest

Other income article

Covers income streams which are not expressly mentioned in any of the abovementioned articles. OECD Model Convention gives the exclusive right to tax to the country of residence. However, India has reserved its position on this article as it wishes to maintain the right to tax income arising from sources in India (e.g. India-Singapore tax treaty)

Most Favoured Nation (MFN)

- More relevant for articles dealing with dividend, interest, royalties and FTS
- E.g.: If India – Singapore treaty has a MFN clause
- If India enters into a tax treaty with any other country in which it offers a lower rate of tax or a narrower scope of income characterisation, then, the benefit of such lower rate or narrower scope will be available to interest earned by Singapore also from India
- Any beneficial treatment provided by India or Singapore to the residents of any third country will be accorded by them to each others’ tax residents also

Limitation of Relief

- Contains some qualifying conditions which must be satisfied by a non-resident if it wants to claim tax treaty relief
- Primary purpose: To ensure that tax treaty relief is provided only in genuine cases
- Different checks and balances:

Criterion	Aim	Statement
Subjective Criterion (PPT / GAAR)	To ensure that obtaining tax benefit is not the principal purpose of the taxpayer (i.e. commercial substance and business rationale test)	A resident of a treaty partner shall not be entitled to treaty benefits of if its affairs were arranged with the primary purpose to take such advantage
Objective Criterion	To screen out the ingenuine attempts to claim tax treaty relief (India-Mauritius and India-Singapore)	A resident of a treaty partner shall not be entitled to treaty benefits unless its expenditure on operations in that country exceeds a prescribed monetary threshold

Avoidance of Double Taxation

- One of the fundamental objectives for which countries enter into tax treaties
- Two types:

Juridical double taxation	same income or capital is taxable in the hands of the same person by more than one country
Economic double taxation	two different persons are taxable in respect of the same income or capital

Avoidance of Double Taxation

- Two leading principles are followed for the elimination of double taxation by the country of which the taxpayer is a resident:

Principle	Meaning	Methods
Principle of Exemption (looks at income)	Country of residence (R) does not tax the income which according to the tax treaty may be taxed in country of source (S)	(a) *__Full exemption:__* Income which may be taxed in country S is not taken into account at all by country R for the purposes of its tax
		(b) *__Exemption with progression method:__* Income which may be taxed in country S is not taxed by country R, but country R retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income
Principle of Credit (looks at tax)	Country R calculates its tax on the basis of the taxpayer's total income including the income from the other country S which, according to the tax treaty, 'may' be taxed in that other country (but not including income which 'shall' be taxable only in country S) Allows a deduction from its own tax for the tax paid in the other country	(a) *__Full credit:__* country R allows the deduction of the total amount of tax paid in the other country on income which 'may' be taxed in that country
		(b) *__Ordinary credit:__* deduction given by country R for the tax paid in the other country is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other country

Special Provisions

- Non-Discrimination
- Mutual Agreement Procedure
- Exchange of Information

Non-Discrimination and MAP

Non-Discrimination	Mutual Agreement Procedure (MAP)
▪ Deals with the elimination of tax discrimination in certain precise circumstances ▪ Seeks to balance the need to prevent unjustified discrimination with the need to take account of legitimate distinctions ▪ Seeks to eliminate distinctions that are solely based on certain grounds (e.g. nationality) ▪ Non-discrimination article shall not prevent India from taxing the profits of a foreign company's PE at a rate higher than that imposed on the profits of a domestic company (this right has been reserved by India)	▪ Institutes a mutual agreement procedure for resolving difficulties arising out of the application of the tax treaty in the broadest sense of the term ▪ Provides that competent authorities should endeavour by mutual agreement to resolve the situation of taxpayers subjected to taxation not in accordance with the provisions of the tax treaty ▪ Authorises the competent authorities to communicate with each other directly, without going through diplomatic channels

Exchange of Information (EOI)

1 **Why are countries inclined in EOI:** Increasing internationalisation of economic relations → countries have a growing interest in the reciprocal supply of information on the basis of which domestic taxation laws have to be administered

2 **Scope of EOI:** Contains the rules under which information may be exchanged, with a view to laying the proper basis for the implementation of the domestic tax laws of the countries and for the application of the tax treaty

3 **Foreseeably relevant:** Only such information can be exchanged as is '**foreseeably relevant**' → countries are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer

4 **Confidentiality and secrecy commitment:** Emphasizes the aspects of confidentiality and secrecy with respect to the information received under this article

Conclusion

Understanding the historical background of tax treaties helps in identifying the **context of a tax treaty**

League of Nations' principle that *specific categories of income should be classified and assigned to source or residence by objective tests of* ***'economic allegiance'*** still holds good. The basis of identifying 'economic allegiance' will continue to change as economies progress and newer business models come up

While interpreting tax treaties, an understanding of the **object and purpose of tax treaties** is extremely helpful

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THANK YOU

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