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Definitions in Tax Treaties and Fiscally Transparent entity

By Adv. Vansh Vermani

What is “Treaty”

Oxford Companion to Law : “Treaty”

“an international agreement, normally in written form, passing under various titles (treaty, convention, protocol, covenant, charter, pact, statute, act, declaration, Concord, exchange of notes, agreed minute, memorandum of agreement) concluded between two or more States, on subjects of international law intended to create rights and obligations between them and governed by international law.

Vienna Convention on law of Treaties 1969 defines “treaty” as :

“An international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation”.

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Principles of interpretation of treaty

- Tax Treaty is an agreement between countries
- Drafted by diplomats, and not lawyers
  - Leads to sloppiness in drafting; implies that care has to be taken so as to not render any word, phrase, or sentence redundant
  - Need to be given a general meaning, general to layman and lawyer alike (SC in Ram Jethmalani & Ors)
- The provisions of Treaty should be interpreted in accordance with the ordinary principle of treaty interpretation as per Article 31(1) of the Vienna Convention on the law of treaties which are:
  - Interpretation in good faith and
  - In accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose

Treaty does not create any additional tax burden; it can only relieve tax **[Principle of non-aggravation]**

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Aids to interpret tax treaties

- Vienna Convention on Law of Treaties (VCLT)
- OECD Model Convention and Commentary
  - Static v. Ambulatory Approach
- Reference to Domestic Law
- BEPS Action Plan Reports
- Foreign Court Decisions

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Vienna Convention on Law of Treaties

Vienna Convention

- **Article 31**: General rule of interpretation
- **Article 32**: Supplementary means of interpretation
- **Article 33**: Interpretation of treaties authenticated in two or more languages

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Vienna Convention on Law of Treaties .. Contd.

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Article 31(1): General rule of Interpretation

- Treaty has to be interpreted in good faith
- Words to be given ordinary meaning
- In the context of the treaty and in the light of its object and purpose

Context (Article 31 (2))

- Preamble and annexes
- Any agreements in connection with conclusion of treaty
- Any instrument in connection with the conclusion of the treaty and accepted by other parties

Article 31(3) provides three more elements

- Any subsequent agreements regarding interpretation
- Any subsequent practice that established agreement of parties regarding interpretation
- Any relevant rules of international law

Article 31(4)

Special meaning shall be given if it is established that the parties so intended

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Vienna Convention on Law of Treaties – India Position

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- While interpreting the word 'public court proceedings' in Art. 26 of India- Germany DTAA the SC observed*:

"India is not a party to the Vienna Convention, it contains principles of customary international law and the principles of interpretation of Article 31 of VCLT, provides a broad guideline as to what could be an appropriate manner of interpreting a treaty in the Indian context."

- Meanings of words in tax treaties, be the ordinary meaning in the context and in light of its object and purpose.**
- Treaties are not to be interpreted as statute, rather like an agreement***
- Literal/legalistic meaning to be avoided when the object is defeated; important to harmonize interpretation with the object and purpose****

**Ram Jethmanlani & Ors. v. Union of India & Ors* (2011) 8 SCC 1(SC)
***Maganbhai Ishwarbhai Patel v. UOI* [1969 AIR 783 (SC)
****New Skies Satellites v. ADIT* [2009]121 ITD 1 (Delhi) (SB).
*****Mashreqbank PSC v. DDIT* [2007] 14 SOT 1 (Mum.).

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OECD Model and Commentary – Relevance for India

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- India: Non-OECD member but key partner
- Active contributor to a host of OECD standard-setting activities dealing with cross-border trade and investment and tax policies.
- Adheres to 14 OECD instruments and is a member of governing body of OECD's development centre.
- Actively participates as an observer in eight OECD Committees and their subsidiary bodies. India has been actively engaged as a member of 'Inclusive Framework on BEPS'.
- Co-chaired OECD/G20 initiative and played a leading role in the BEPS project.

Despite India being a non-member country – OECD MC, Commentaries and TP Guidelines hold persuasive value in India

India is also a member of:

- Development Centre,
- the Global Forum on Transparency and Exchange of Information for Tax Purposes,
- the International Transport Forum,
- the Financial Action Task Force, and
- an Association Country of the International Energy Agency.

Engagement in the G20 context includes India's active role in the Global Forum on Steel Excess Capacity and its adherence to the G20/OECD Principles of Corporate Governance.

Indian ministers and officials have also attended the OECD Ministerial Council Meetings.

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OECD Model and Commentary – Relevance for India

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ITATs and Courts have ruled both in favor and against relying on the OECD commentary for treaty interpretation

Union of India v. Azadi Bachao Andolan (SC) [2003] 132 Taxman 373 (SC)]

The Court referred to OECD MC and Commentary for the interpretation of term ‘liable to tax’ in Art. 4 of India –Mauritius DTAA (India has subsequently introduced definition of ‘liable to tax’ in its domestic tax law)

Asia Satellite Telecommunications Co. Ltd. v. DIT, (Delhi HC)[2003] 85 ITD 478 (Del.)

For better understanding of technical terms mentioned in treaty, OECD Commentary can always be relied upon. In *Metchem Canada v. DCIT,* Mumbai ITAT also followed a similar reasoning.

Contrary opinion

CIT v. P.V.A. Kulandagan Chettiar [(2004) 267 ITR654 (SC)]

In the context of interpreting the word ‘may be taxed’ under Art. 7 of India - Malaysia treaty the SC held: Section 90 enables the government to formulate its policy through treaties; hence, to interpret a particular treaty it would be unnecessary to refer to the terms addressed in the OECD Commentary or in any of the decisions of foreign jurisdictions or in any of India’s DTAAs.

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OECD Model and Commentary – Static v. Ambulatory Approach

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Static Approach: The interpretation of a tax treaty should be based on the provisions relevant at the time of finalization of the tax treaty.

Ambulatory Approach: Tax treaty is interpreted on the basis of meanings prevalent in the current world, i.e. at the time of application of the tax treaty.*

*Certain Indian treaties signed with South Africa, Australia, Mexico, Hungary, Saudi Arabia and Kazakhstan provides for ambulatory approach

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Reference to Domestic Laws

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Article 3(2) of OECD and UN Model Conventions:

- If a term is **not defined** in a treaty;
- And **the context does not otherwise require a different meaning**;
- The meaning of that term will consequently be provided by the **domestic law** of the contracting countries, and the domestic tax law shall be **given preference** over any other law of such country.
- Where a term is not defined under the domestic tax law, any other domestic law can be referred to and the term should be accorded the meaning under that law which best suits the context in which it has to be interpreted. *

*India's treaty with Luxembourg, South Africa, Hungary, Armenia, Mexico, etc. have incorporated such principle.
Section 90(3) of ITA: Any term used but not defined in the ITA or the tax treaty shall, unless the context otherwise requires and is not inconsistent with the provisions of the Act or the tax treaty, have such meaning as is assigned to it under any notification issued by Indian Government in this regard.

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Reference to Domestic Laws … Contd.

Article 3(2) of OECD and UN Model Conventions:

- Before applying the domestic law meaning for a term which is undefined in the treaty, it is necessary to see whether such meaning is consistent with the context in which the term is used in the tax treaty, so that the purpose of the relevant provision of the tax treaty is not frustrated.
- While determining the meaning of words used in tax treaties, their ordinary meanings need to be seen in the context and in light of the objects and purpose of the tax treaty, so that the treaty is interpreted in good faith and it is workable rather than redundant.

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Article 2 : Taxes covered - India- USA Treaty

ARTICLE 2 - Taxes covered - 1. The existing taxes to which this Convention shall apply are :

(a) in the United States, the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes)….

(b) in India :

(i)the income-tax including any surcharge thereon, but excluding income tax on undistributed income of companies, imposed under the Income-tax Act ; and

(ii)the surtax

State taxes levied by US not covered under India –US tax treaty

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Article 7 - Business Profits – India-UK treaty

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enter price **may be taxed** in the other State but only so much of them as is directly or indirectly attributable to that permanent establishment.

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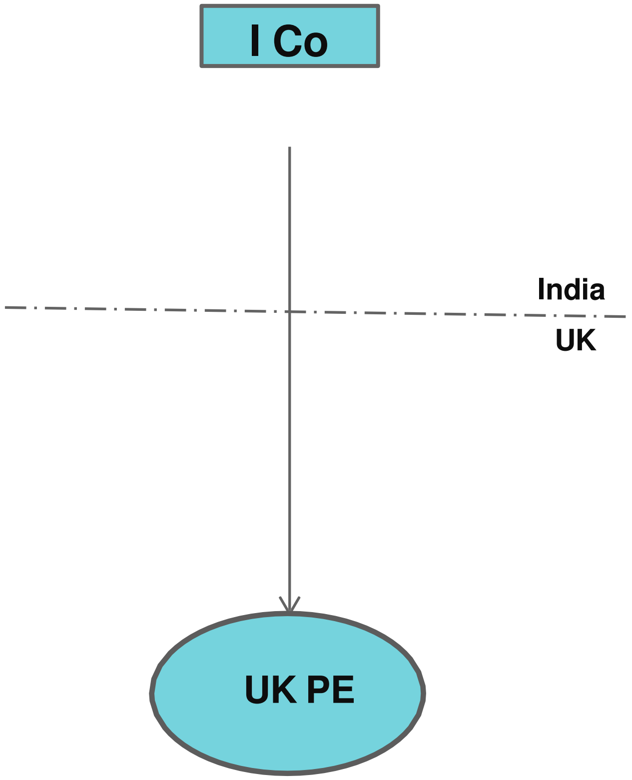
The Expression “may be taxed”



- As per Article 7(1), if the enterprise (I Co) carries on business as aforesaid, the profits of the enterprise “may be taxed” in the other State (UK)
- The term 'may be taxed’ would accord right to tax to source country (i.e. UK)
- May be taxed permits source taxation as well and does not exclude residence taxation (Delhi ITAT in case of Telecommunications Consultants India Ltd)
  - Decision of SC in CIT v. P.V.A.L Kulandagan Chettiar (267 ITR 654) (SC) proceeds on the basis that treaty residence was in Malaysia
- Notification No. 90 and 91 of 2008 clarifies when a treaty provides that any income of a resident of India “may be taxed” in the other country, such income shall be included in his total income chargeable to tax in India

‘May be taxed’ coupled with source country right restricted to a specified rate

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Article 13- Royalties and Fees for Technical Services [Para 1& 2] (India-UK treaty)

1.Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2.However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the law of that State; but if the beneficial owner of the royalties or fees for technical services is a resident of the other Contracting State, the tax so charged shall not exceed 15 per cent of the gross amount of such royalties or fees for technical services

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Article 13- Royalties and Fees for Technical Services [Para 1& 2] (India-UK treaty)

UK Company as recipient of Income

Royalties and fees for technical services arising in India and paid to a resident of UK may be taxed in UK.

However, such royalties and fees for technical services may also be taxed in India in which they arise and according to the law of India; but if the beneficial owner of the royalties or fees for technical services is a resident of UK, the tax so charged shall not exceed 15 per cent of the gross amount of such royalties or fees for technical services

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Source rule - Treaty

- General Source rule :
  - Payer rule: deemed to arise in India when the payer is
    a) Indian State itself, a political sub-division, a local authority of India
    b) or a resident of India.
  - PE rule: Country of Permanent establishment/ fixed base
    a) in connection with which the liability to pay FTS is incurred
    b) Such fees are borne by such PE/ FB
  - PE can be of enterprises of treaty resident or any person

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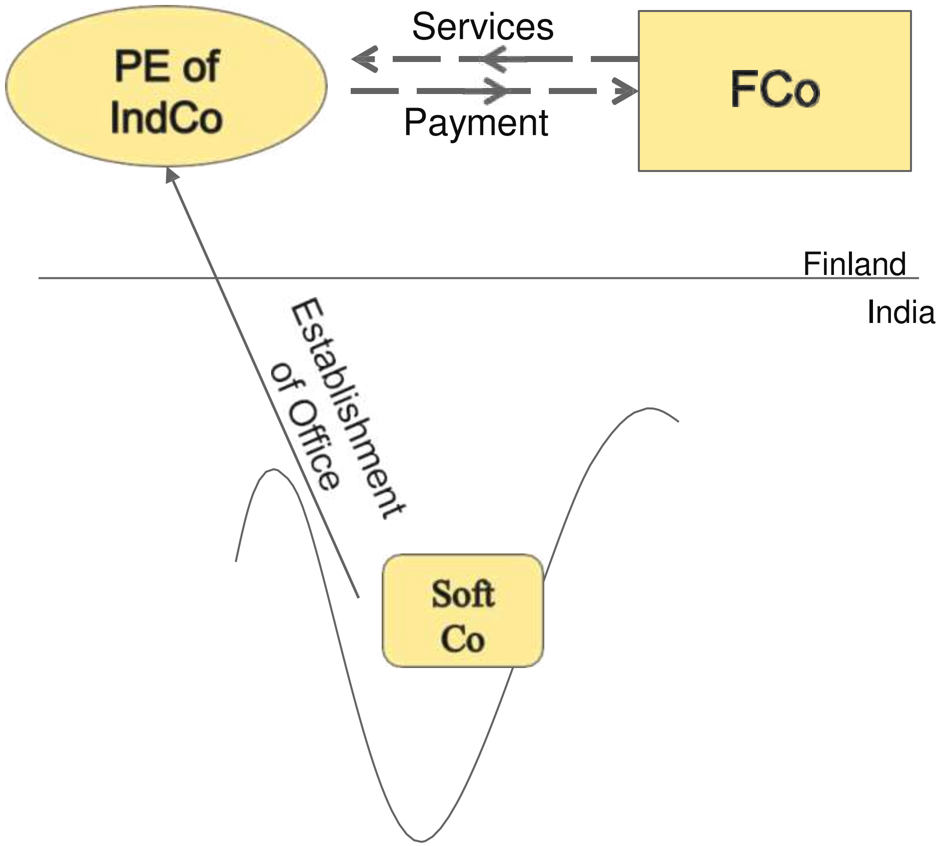
Significance of PE linked Source Rule



- Soft Co, an Indian company is in the business of development of software
- Soft Co established an overseas office for onsite support
- Overseas branch of I Co appoints F Co for designing interiors of branch
- Payer to F Co is an Indian resident
- F Co sources income where PE of ICO is i.e. Finland

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Restricted source rule

- Article 12(5) of India Finland Treaty

  Fees for technical services shall be deemed to arise in a Contracting State (India) when the payer is that (India) State itself, a political sub-division, a local authority, or a resident of that State (India). Where, however, ……………… when the fees for technical services relate to services performed, within a Contracting State (Finland), then such fees for technical services shall be deemed to arise in the State in which the services are performed (Finland).

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Fiscally Transparent Entities

- OECD Report on Partnerships (1992) noted :
  - Not clear whether the partnership is a “person” under the MTC
  - Fiscally Transparent Partnership “Not Liable” as Not RESIDENT
  - Treaty benefit may be given to partners, but can be withheld if information is not readily available
- Article 1 of MTCs amended in 2017 to incorporate treaty benefits for fiscally transparent partnerships
- Article 3 of MLI applies this to CTAs

…States should not be expected to grant the benefits of a bilateral tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, if an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income.

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