

Indian Double Taxation Agreement and Tax Laws - Introduction of Indian Double Taxation Agreement and Tax Laws

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DOUBLE TAXATION AGREEMENT - DOING BUSINESS IN OR WITH INDIA

IntroductionIntroduction

1.1 Doing business with a country connotes exporting goods or merchandise, capital, services, technical know-how and expertise etc. It has no bearing on investment or flow of investment from one country to another. Many merchants and manufacturers export their goods to all countries of the world. No one can, however, say that they carry on trade in every such country. If all that a merchant does in a country is that he solicits order, he cannot reasonably be said to exercise or carry on trade in that country. What is done there is only an ancillary to the exercise of his trade. Solicitation of customers does not in all cases amount to his trading within there. For a non-resident to be charged to tax in a country with respect to his trading activity, it is necessary that he trades within that country, as distinct from doing trade with it. Doing business within a country means indulging actively in some economic activity in that country that produces income, through an agent or broker or directly by establishing branch or any other type of permanent establishment and not seeking order. The mere fact that a substantial part of goods finds its way in another country or is sold through brokers does not amount to doing business in that country.

Doing business, meaning ofDoing business, meaning of

1.2 The term "doing" or "engaging in" or "transacting" business implies a continuity of commercial dealings and arrangements, and contemplates, to that extent, the performance of acts or work or exercises of some of the functions normally incident to and in progressive prosecution of commercial gain or for the purpose and object of the business organisation. Doing business includes soliciting orders, service contracts, opening of offices, whether called liaison offices or branch offices, appointing representatives or distributors, participating in the management, supervision or control of any domestic business, firm or corporation, and any act or acts that imply continuity of commercial dealings or arrangements. It does not, however, include mere investment as shareholder and/or the exercise of rights as such investor; nor having a nominee-director or officer to represent his interest in such corporation; nor appointing a representative or distributor who transacts business in his own name or account. The mere activity which facilitates receipt of orders from local distributors without contributing any thing towards pricing, distribution and marketing pro-duct is not doing business.

The distinction between doing business in or doing with has been established in *Grainger & Sons v. Gough* (3 TC 462):

"if all that a merchant does in any particular country is to solicit orders, I do not think he can reasonably be said to exercise or carry on his trade in that country. What is done there is only ancillary to the exercise of his trade in the country where he buys or makes, stores, and sells his goods....(if) the contract of sale (is) made abroad and delivery (takes) place there, I find myself quite unable to see how the mode in which orders are solicited and obtained, whether by an agent or by circulars or advertisements can make any difference and cause the trade in one case to be exercised and in the other not to be exercised within this country."

In deciding, it is to be determined where the contracts for the sales concluded. That determination is based on the substance rather than the form of the transaction. For example, if the negotiations are undertaken in a country and substantially agreed upon, it is that country where the contracts can be said to have taken place and not in that in which it is formally signed. The question therefore, boiled down, in the words of Lord Atkin in *Smidh & Co. v. Greenwood* [1922] 8 TC 193 (HL) "where do the operations take place from which the profits in substance arise". It is the place where goods are manufactured, contract of sale made, delivery taken.

Doing business with or within India

1.3 A company wishing to trade in India requires to establish a structured business operation to reflect its requirements. It may establish a branch office, or a joint venture company, or a subsidiary company, to have a direct access or contact with the Indian markets, or any other business presence so that a common thread of mutual interest must run through the fabric of trading activities carried on outside and inside the taxable territory. The commonness of the interest may be by way of management control or financial control or by way of sharing of profits. There must be something more than the mere transaction of purchase and sale between principal and principal. The selection of the business presence depends upon the nature of investment and tax and other advantages associated with each, as also the industrial and investment policy of the Government. A branch is its extension in India with no separate legal identity. It runs its own affairs subject only to overall direction from the head office. A joint venture is a commercial arrangement between two parties who have agreed to conduct business together for a particular purpose. A subsidiary company is registered under the Indian Companies Act. It is a separate legal entity from its parent. The liability of the parent company is limited to its share capital. It would be treated as an Indian company, irrespective of how it is managed. There is thus a basic international acceptance of the principle that a business carried on in a country by a foreign enterprise is taxable if it is carried through the aforesaid business presence, *i.e.*, the fixed place, known as permanent establishment. Apart from fiscal, there may be various reasons for a foreign company to carry on its business activities through permanent establishment rather than through a subsidiary. It may be because of lack of understanding and knowledge of the foreign market or because of the nature of the activity being such as incorporation of a subsidiary is not necessary. For example, construction industry or the petroleum industry which is characterised with a high degree of mobility which do not require permanent location as their operation lasts till the assignment and not intended to be permanent. The presence cannot be called permanent establishment if the activity is confined to collection of information or performance of such activities of preparatory or auxiliary nature. Only, if the activities go beyond providing such support functions, the profits are taxable. That question is a question of fact. It depends upon the nature of the transaction. Precise rules, however, cannot be laid down. The question is whether the profits brought into charge in a country are the profits accruing or arising from any trade exercised in that country. A trader exercises the trade by buying and selling a commodity, and, a manufacturer by manufacturing a product and selling it, both with a view to making a profit. Before deciding a question where profit is derived, it is necessary first to determine how, and then where, it is done. That determination would mean determination of the source of income.

Source of income - Accruing or arising in India - Source rule

1.4 The Indian taxation is based on the principle of the residence of the person and the source of income. Worldwide income of the Indian residents is taxable in India, though section 91 of the Indian Income-tax Act, 1961, provides relief by way of credit in respect of the tax paid on their foreign income, if the source is in the country with which there is no tax treaty ; otherwise the relief is provided according the provisions of the treaty. Non-residents, however, are subject to a source-based taxation. The Indian income-tax system is based on source; only amounts received or accrued from a source, or so deemed within India are subject to income-tax. Section 5 of the Indian Income-tax Act, 1961 defines the scope of total income, as all income from whatever source derived by a person who is resident which is received or is deemed to be received or which accrues or deems to accrue in India. Income accrues or arises outside India is also included; which is not done in case of a person who is non-resident, who are taxed only on the Indian sourced income. Territorial test is set out in section 5. Tax is imposed on income which accrues or arises or is received in India, derived from whatever source. It means that a person is liable if he has income from a source which is situated in India or income which accrues or arises from a source wherever situated even outside India. Territorial nexus for the purpose of determining the tax liability is an internationally accepted principle [*see Ishikawajma - Harima Heavy Industries Ltd. v. DIT* [2007] [158 Taxman 259](#) (SC)]. The territorial test has been set out in section 5 under which tax is imposed on income accruing in, derived

from, or received in India. It would mean that the taxpayer will be liable to tax if he has income from a source which is situated in India or if he receives in India from a source wherever situated. In principle, nationality or residence of the taxpayer is not relevant. Territorial nexus notwithstanding, section 9 of the Income-tax Act deems income in certain cases as derived from India. Such cases deal with business income, property income, employment income, and income as dividend, interest, royalty, fees for technical services. As regards the last type (dividend, interest, royalty, fees for technical services), payments made by the state or the Indian resident are deemed to have been derived from India and hence charged to tax by the recipient, even though the "source" of payments may not be in India, and the recipient did not receive them in India. However, in view of the Supreme Court of India, such payment would come within the purview of taxability if it has territorial nexus with India [see *Ishikawajma-Harima Heavy Industries Ltd. v. DIT* [2007] [158 Taxman 259](#) (SC)]. The Income-tax Act has now been amended by inserting an *Explanation* under section 9, declaring that income is includible in the total income of the non-resident, whether or not the non-resident has a residence or place of business or business connection in India. Thus, the territorial nexus which according to the Supreme Court was necessary for taxability is not relevant; nor is relevant the residence of the person. In case of non-resident, income accruing or arising outside India is not taxable. If the source is in India, income is taxable ; residence or nationality has no relevance. The "source" doctrine is preferred to the "residence" doctrine, but modified by the introduction of "deeming clauses", laying down that in certain circumstances income which accrues or arises from a source outside India would be deemed to have been derived from a source in India and hence taxable section 9 of the Indian Income-tax Act, 1961, contains a number of provisions which deem certain forms of foreign source income to be of Indian source. Income of a non-resident taxpayer is taxable in India, only if it is Indian sourced. It is also otherwise taxable, if it accrues or arises in India in terms of section 9 of the Indian Income-tax Act, 1961. Such incomes are those which accrue or arise.

a. directly or indirectly through or from any :

- business connection, or
- property, or
- asset or
- source of income, or
- through transfer of a capital asset situate,

in India;

Only such income is so deemed which is attributable to business operations carried out in India, if all are not done. In the case of non-resident no income is deemed to accrue or arise in India—

- from the business operations which are confined to the purchase of goods in India for the purpose of export ;
- from the activities which are confined to the collection of news and views in India for transmission out of India, if he is engaged in the business of running a news agency or of publishing newspaper;
- from the operations which are confined to the shooting of any cinematograph film in India, if he is not a citizen of India or any of its partner or any shareholder is a citizen or resident of India.

- b. Salary income if earned in India or payable by the Government to a citizen of India for services outside India;
- c. Dividend income if dividend is paid by an Indian company outside India;
- d. Income by way of Interest, Royalty, or Technical fee, if payable by Government, or person who is resident in India or who is non-resident (except where money borrowed, right, property or information in respect of which royalty is paid, is for the purpose of a business or profession carried on outside India) or who is non-resident where the business or profession is carried in India.

The source rule sets above indicates that income is regarded as derived from Indian source if the origin of the income (property or asset) or the activity generating income is located in India. Source of income could be said to be lying in India, if the capital or the labour which produces the income is in India. Source rule in respect of several types of income is given below:

- *Trading Business* - Income from trading business arises where sale of inventory goods takes place, *i.e.*, where the title to the property passes from seller to the purchaser. However, in the case of non-resident income from

the sale of goods which is attributable to the fixed place of business in India or made through an agent in India, is treated as Indian source;

- *Manufacturing business* - Income from the manufacturing business is allocable to the country of manufacturing and the country of sale, as both the countries contribute to the income generating activity;
- *Any business carried on in India* - Income derived from any business wholly or partly carried on in India;
- *Any business carried on outside India* - Income derived from any business carried on outside India to the extent that that income consists of the income classified as royalties or fees for technical services payable by any person who is resident in India in respect of business carried on by that person outside India, or payable by a non-resident for the purposes of business carried on in India;
- *Property leasing* - Income derived from leasing or licensing property situated in India, arises in India;
- *Capital asset transfer* - Income derived from the sale or other disposition of any property, corporeal or incorporeal, situated in India;
- *Services (personal, i.e., salaries, wages, allowances, and emoluments)* - Salary is taken Indian sourced, if earned in India, i.e., services rendered in India;
- *Services (professional)* - The same principle applies as to the income from personal services (salary). Income arises where services are rendered.
- *Services (technical)* - Income by way of fees for technical services is deemed to have Indian source, if paid by the Government, or the Indian resident (excepting where business is carried on outside India), or the non-resident (if the business is carried on in India or for the purpose of making any income from any source in India) ;
- *Dividend* - Dividend paid by an Indian company is regarded Indian sourced ;
- *Interest* - Income by way of interest is regarded having Indian source, if paid by the Government, or the Indian resident or the PE of the non-resident;
- *Royalties* - Income by way of royalties is deemed to have Indian source if paid by the Government or the Indian resident or the non-resident PE in India and utilised in India;
- *Other income* - Income derived directly or indirectly from any other source in India.

Section 9 uses the expression "through" or "from". The word "from" means showing origin or cause and the word "through" means the medium for earning income. If the source is say any property, the income could be said to have been derived from it. If it is not the source but helps in earning, income could be said to have been derived through it. Income could be derived through premises equipment or agent, a market place, road construction, laying of pipe-lines, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand, customs depot etc. The income yielding activity must be done through premises, equipment or a person. The matter is discussed in detail in paragraph 11.5-4.

It could thus be seen for determining taxability of an income in India, it is necessary to ascertain;

- source of income, i.e., the originating cause,
- nature of income, i.e., whether it is trading profits, salary, interest, dividend, royalty or technical fee,
- geographical location of the source.

Source of income - The originating cause

1.5 The expression "source" has not been defined in the Indian Income-tax Act, 1961. It has also not been done in any of the OECD or the UN Model for Double Taxation Convention. To constitute income, profits or gains, there must be source from which the particular receipt has arisen, and a connection must exist between the quality of receipt and the source. Source is not only a legal concept but also something which a practical man would regard as a real source of income. The source of the receipts, received as income, is not the quarter whence they came, but the originating cause of their being received as income.

Section 5 of the Indian Income-tax Act says "income derived from a source" and not "income received" in India. The source is not the source of payment but the conduct or action which is the reason for the obligation being accepted. Conduct or action represents the real source. Income arises or is received in India if the services are

rendered in India, or the property in respect of which income is derived, is in India, or the transaction which produces the income has an Indian environment.

Isaacs J. in the decision of the High Court of Australia in *Nathan v. FCT* (1918) 25 CLR 183 said:

"The legislature in using the word 'source' meant, not only a legal concept, but something which a practical man would regard as the real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact."

In *CIR v. N.V. Philips* (1955) NZLR 868, North J, adopting the Nathan test, held that the crux of this test is (at p. 888):

"A practical man of business would conclude that all income had its origin either in 'work' or in ownership of 'property', using both the terms in their widest sense."

Property is one possible source of income. The work of or acts by persons are other possible sources of income. There is no source of income other than property or acts done. A person who neither owns anything in a country nor has done anything in that country cannot derive income from that country - *FC of T v. United Aircraft Corporation* [1943] 7 ATD 318. If the originating cause is the work which the taxpayer does to earn it, *quid pro quo* which he gives in return for which he receives. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is the combination of these - *CIR v. Lever Brothers & Unilever Ltd.* [1946] 14 SAC 1. The source of income thus, is the originating cause.

In order to determine the source of income two issues must be resolved. First, the originating cause of the income must be found. Once that has been done, the location of the originating cause must be determined. The source of income will be where the originating cause is located.

It may either be the work done or the employment of the property. In determining the originating cause, what is to be determined are :—

- Nature of income;
- What has been done to derive the income; and
- Where done.

Source and nature of incomeSource and nature of income

1.6 If a payment is by a person, it must be found out why the payment has been made; what the taxpayer has done and where. "What" and "where" are the two questions which require determination, to know the nature and the location of income. Nature of income determines the rate of tax at which such income is to be taxed. It is because tax treaties and also various income-tax legislation are structured on a scheduler basis. Different categories of income are treated differently. There are different articles in the treaties and the tax legislation dealing with business profits, royalties, interest, dividends, personal or independent service income. The rates of tax is different for each category. Business income in the international context is taxed at the normal rates in the country of source on net basis as the taxpayer has sufficient business presence. Royalty, interest or dividends are taxed on gross basis at rates usually below those applied to income taxed on net basis; the tax is collected by withholding. The rates for withholding vary from jurisdiction to jurisdiction and from one treaty to another. It is normally 10 to 15 per cent. It may be even less, or zero. The nature also assigns tax jurisdiction. Since rates of tax vary and the margin of variation is wide in some cases, Transnational Corporations (TNC) have been resorting to devices to shift income from one jurisdiction to another, or to classify it differently. Such devices are known as transfer pricing, thin capitalisation, treaty shopping etc. Transactions are structured between the subsidiaries in such a manner so that the profits are manifested elsewhere than where they belong. By so doing, the profits are made to suffer least or no tax at all. Transactions are not done at arm's length (transfer pricing). Capital is provided as debt and not as equity (thin capitalisation). Investment in another country is not made directly, but through the series of conduit entities in various jurisdictions in order to make use of treaties between the concerned countries (treaty shopping). Such devices are discussed with details, later.

The nature of income is very relevant. What is income from investment for one person is income from business for another. In case of *American Leaf Blending Co. Sdn Bhd v. DG of IR* [1978] STC 561, the Privy Council found that

the rents from letting out warehouses for a short period of time were received in the course of carrying on the business of putting the taxpayer's property to use by letting it out for rent and were properly described as pro-fits from business rather than rents. Thus, if the tax payer derives income by exploitation of its commercial assets such income is business income. Whether income is a business income or the income from investment, the question is to be decided from the point of view of the taxpayer's intention, whether, he intended to go out of the business. In *CEPT v. Shri Lakshmi Silk Mills Ltd.* [1951] [20 ITR 451](#) (SC), it was held that leasing of a dyeing plant for a short period was a business income. In *CIT v. Vikram Cotton Mills Ltd.* [1977] [106 ITR 829](#) (All.), it was held that the company had no intention to discontinue its business, and that the income derived from the lease of the plant and machinery was a business income. Temporary suspension of business activity does not render income from leasing out commercial asset as income from property. It is business income.

Income - Place where accrues - Guiding principles

1.7 The following passage from the decision in *CIR v. Hang Seng Bank Ltd.* [1990] 3 HKTC 351 (PC) provides the guideline for determining the place of arising of profits. Lord Bridge said :

"The broad question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rule of law by which the answer to the question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in activity such as the manufacture of goods, the profit will have arisen or derived from the place where service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and selling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."

The acts which are the sources of income are, "rendering" (services), engaging (activity), or, exploiting (property). The place where the act is performed is the place where profit arises. The emphasis is on performance and not on negotiating or entering into agreement.

The guiding principle is "One looks to see what the taxpayer has done to earn the profit in question". This principle was expanded by Lord Juancey in *CIR v. HK-TVB International Ltd.* [1992] 3 WLR 439 (CA), to read as "One looks to see what the taxpayer has done to earn profits in question and where he had done it". Lord Juancey had no doubt that when Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or determined from a particular jurisdiction.

Source of income - Location of the profits

1.8 Location of the source of income in the context of international taxation has to be found out. It is necessary for the assignment of jurisdiction and to determine where the income arises and be taxed. Source is not a legal concept, but something which a practical man would regard as a real source of income (Lord Atkin in *Liquidator Rhodesia Metals Ltd. v. CIT* [1940] AC 774). Where do the operations take place from which the profits in substance arise, is the question - *F. L. Smith & Co. v. Greenwood* [1921] 3 KB 583.

The guiding principle in any question of source is the statement of Lord Bridge as expanded by Lord Juancey, "One looks to see what the taxpayer has done to earn the gross profits in question and where he has done it".

Source of profits - Two kinds

1.9 The above guideline presupposes that the transaction has resulted in accrual of gross profits; and then divides those profits in two categories

1. Profits from property, and,
2. Profits from activity.

The said guideline refers to gross and not the net profits. How the concept of gross profits is relevant in determining the place of accrual of income is discussed later.

Property in 1 above is the source. It may be immovable or movable (including goods or merchandise or any other commodity). Profit may arise from letting or leasing or dealing in the property. In this category falls income from

buying and selling as in trading (business) or as capital asset (capital gains), leasing, licensing, or lending. In the second category falls income from manufacturing, agency business, profession, or personal employment. Broadly in case of 1, profit arises where the property is situated or transferred, as stated by Lord Bridge in *Hang Seng Bank* case, ".... if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and selling at a profit, the profit will have arisen from the place where the property was let, the money was lent or the contracts of purchase and sale were effected." The place where the property is let is the place where the property is situated and not where the lease happened to be signed. Money is lent where the credit is provided. Property is the source in case of trading; activity, in case of manufacturing. In case of trading it arises where contracts of purchases and sale are effected. In case of manufacturing, it arises where manufacturing is done. The place where decisions are made is not relevant - see *CIT v. Chunilal B. Mehta* [1938] [6 ITR 521](#) (PC). Where business in general is carried is also not important. The source of income is, therefore, not identical with the place where the business is carried on [see *Mount Morgan Gold Mining Co. Ltd. v. CIT* [1923] 33 CLR 76.]

Profits from property are :

- a. Letting property; (the location of profit is the location of the property)
- b. Lending money; (the location of the profit is where the money is lent) and,
- c. Dealing in commodities by buying and selling; (the location of profit is where the contracts of purchase and sale effected)

Profits from activity are :

- d. Rendering services, (the location of profit is where services are rendered) and,
- e. Engaged in an activity, such as manufacture of goods (the location of profit where manufacturing is done)

CIR v. Hang Seng Bank Ltd. [1991] 1 AC 306 (PC).

Property as the source of income Property as the source of income

1.9A Profits from property could arise by the operation of investment or by operation of sale. In the operation of investment, income is produced while the asset continues to belong to the taxpayers. In the operation of sale, gain is produced, which is still income, but title to the asset is parted with. Although the process involved in the two cases are different, the gain which has resulted to the owner of the asset, in each case, is the gain which has sprung or arisen from the asset - *Sevantilal Maneklal Sheth v. CIT* [1968] [68 ITR 503](#) (SC). The source is the property. The operations are different; operation of investment, and the operation of sale. The operation of sale could be further classified into two categories, depending upon nature of the property and the intention of the holder. If it is held as capital asset and sold, capital gain arises, if it is held as stock-in-trade, trading profits arise. Trading profits are, therefore, profits from property.

The location of the income is where the capital is employed. This test has often been used in conjunction with a "place of business", as the capital of a taxpayer is often employed where the business is carried on.

Profits from letting out property Profits from letting out property

1.10 Property can be exploited as a source of income by letting it out. It may be immovable, movable or intellectual. In case of immovable, income arises where the property is situated, and not where the lease happened to be signed. In case of movable, it arises where the property is delivered by the lessor, and not where the lessee uses it.

Profits from licensing of intellectual property Profits from licensing of intellectual property

1.11 Licensing of intellectual property rights is not like letting other type of property. It would then presuppose that the intellectual property rights have a situs similar to immovable property. In *CIR v. HK-TVB International Ltd.* [1992] 3 WLR 439 (CA) a company was granted rights to broadcast and export of TVB's films and other programmes outside Hong Kong. It was held that profits arose in Hong Kong as the operations in Hong Kong guaranteed the profits from selling rights to use the film and broadcast. In *FC of T v. United Aircraft Corporation* (2 AITR 458, an Australian case), the matter related to the supply of know-how. A US corporation furnished plans and specifications, information and advice as to production to an Australian concern to enable to build aircraft engines. It was held that the delivery of know-how took place outside Australia under a contract concluded outside

Australia and that, consequently, the source of the income was outside Australia. However, the Indian law deems such income as accruing or arising in India. The issue will be discussed at the appropriate place.

Profits from lending money

1.12 The place where the money is lent is the place where profit arises. It is a place where the provision of credit to the borrower is given. It is not the location of payer which determines the source of interest income. It is the place where the capital sum of loan money passed from the lender to the borrower - *CIR v. NV Philips Gloeilampenfabrieken* [1954] 10 ATD 376. Interest on trade debts fall in different category. The source is not lending money. It is the trade debt. Income arises where seller sold goods or provided services - *Studebaker Corporation of Australia Ltd. v. C of T (NSW)* [1921] 29 CLR 225.

Profit from trading - Location (Contract conclusion test)

1.13 Trading profits, as aforesaid, are considered profits from property. A trader is paid for goods or other property, rather for activity of any kind. A trader purchases commodities and sells them at a higher price, such as a money lender borrows money and lends at a higher rate. If the place of income is where the money is lent, the place for the trader's income is where the property is sold, that is, where the sale is effected. Like the provision of credit, or the provision of the leased property, the provision of the property which is the subject-matter of trade's contract of sale is the event by which the trader performs its obligations and performs the contract. Therefore, the trader's profit will arise in or is derived from a place where the sale is effected *i.e.*, where the property is provided to the buyer. In the case of merchant's business, the primary object is to sell goods at a profit. It is at that stage profit arises. In *Grainger v. Gough* [1896] AC 325 (HL), Lord Herschell says, "How does a wine merchant exercise his trade? I take it, by making or buying wine and selling it again with a view to a profit". In that case a French wine merchant was concluding the contracts for sale of wine to English customers in France. The House of Lords held that, since the contracts were made in France, the wine merchant was not subject to English tax. It did not matter that the shipments were made to the customers in England and the French merchant employed agents in England and engaged in various promotional activities in England. It is sufficient to consider only where it is that the sale contracts are made which result in profit. The contract conclusion test is applied in the case trading companies - *Smidth & Co. v. Greenwood* [1922] 8 TC 193 (HL). In *Maclaine & Co. v. Eccott* [1926] 10 TC 481 Viscount Cave LC concluded that the contract conclusion test has been established with respect to trading merchants, "I think it must now be taken as established that in the case of a merchant's business, the primary object of which is to sell goods at a profit, the trade is exercised or carried on at the place where the contracts are made." Conclusion of contract does not mean negotiation or entering into but transfer of ownership of the subject matter of goods (discussed in the following paragraph). The general source rule for trading income is that profits accrue at the place where sales are effected, as a practical, hard matter of fact.

"Effected" meaning of, when sale is said to be effected

1.14 As aforesaid, the profits from dealing in commodity arises where contacts of purchase and sale are effected. Commodities are generality of goods which are subject to trade, and not necessarily tangible goods. "Effected" in relation to contracts of purchase and sale of commodities means "performed" or "carried out" as opposed to "entered into" or "negotiated". Generally performance of a contract results in profit. Income under a service contract arises from where services are performed; under a lending contract, where the contract of providing credit is performed, and under a lease of real property contract, where the contract is performed by providing property to the lessee. It is the performance of the contract by a taxpayer which earns profit. In the case of contract of selling goods, the criterion cannot be different. It is the performance which yields profit. The expression "effected" cannot be meant differently from performance. Contracts of sale effected means contracts performed or carried out, and not where negotiated or entered into. It is where sale is made and goods handed over. Lord Bridge, while laying down the aforesaid guideline as to what the taxpayer has done, did so as an answer to a question "... the question whether the gross profit resulting from a particular transaction arose in or derived from one place to another is always in the last analysis a question of fact depending on the nature of the transaction". The question related to arising of gross profit and not the net profit. The question, therefore, veered round on the amount received on sale *i.e.*, where the sale is effected.

The Supreme Court in *20th Century Finance Corporation Ltd. v. State of Maharashtra* [2000] 6 SCC 12; [2000] 119 STC, held that where goods are available for the transfer of the right to use sale would be the place where the

contract is executed and not where the goods are located for use and in case where goods are not in existence or where there is oral or implied transfer, the transaction may be effected by the delivery of the goods (*see also the decision of the Supreme Court in Bharat Sanchar Nigam Ltd. v. Union of India* [2006] 282 ITR 273).

Sale - When complete - Offshores

1.14-1 A sale is a business transaction involving delivery of a commodity, an item of merchandise or property, a right, or a service, in exchange for a price. It is complete when goods have been delivered. For example, if the seller transfers the property in goods immediately to the buyer, as a sale of an article across the counter, there is a sale. But if the parties have expressed their intention about the time when, or the conditions and circumstances under which, the property passes, sale would be complete when such time elapses or the conditions satisfied. Transfer of goods on approval would not be taken sale until the goods have been formally accepted by the buyer or the time period for rejection has elapsed or the return of goods has become impossible by the buyer's own act or default. In consignment sales, whereby the recipient of goods undertakes to sell on behalf of the seller, sale would be recognized when goods have been sold to the third party. If the sale of goods is subject to their installation or inspection, it cannot be said to be complete unless the customer accepts delivery and installation or inspection done as per terms agreed upon. In some cases, however, installation or inspection process may be so simple in nature that transaction of sale can be said to be complete without waiting for installation/inspection, as in the case of a television set. Sale could also be recognized even when, under some circumstances, physical delivery has not been completed. Delivery of the bill of lading while the goods are afloat is equivalent to the delivery of the goods themselves. A railway receipt is the document of title to goods and for all purposes represents goods. When the railway receipt is handed over the consignee on payment, the property in goods is transferred. Thus, the goods in transit, *e.g.*, where they are at sea or on railway, can be sold by handing over the bill of lading or the railway receipt representing goods. In mercantile contracts, sale is complete as soon as constructive or symbolic delivery is effected by transfer of bills of lading, railway receipts, warehouse keepers' certificates, delivery orders, dock warrants and other instruments showing title to goods. By such transfer significant risks and rewards of the goods sold have been transferred. If the risk and the reward, while the goods in transit, is not of the buyer there is no transfer of property in said goods and delivery cannot be said to have been made by handing over the said documents.

In order to decide whether the business transaction is complete, the question of vital importance is not whether the title in the property have been passed but whether the significant risks and rewards of the asset sold have been transferred. The test to decide whether significant risks and rewards of ownership have been transferred are: (i) whether the seller retains any effective control over the goods transferred to an extent normally exercised by an owner; and (ii) whether any significant acts of performance remain to be completed.

Who bears the insurance risk during the course of journey may be a relevant factor when the property in the goods has passed. If the seller bears, goods cannot be said to have been delivered during the course of journey. Whose risk is important and not who pays the amount of insurance. In a c.i.f. agreement, insurance and freight up to the delivery to a foreign port are borne by the seller, beyond which the purchaser assumes any further handling, insurance and transportation charges; in an f.o.b. agreement, the invoice cost includes the cost of delivery at the seller's risk at an agreed point beyond which all transportation and delivery costs and risks must be borne by the purchaser. FOB, say London, means delivery by the seller to a freight terminal in that city; freight, handling charges thereafter are to be borne by the buyer (say of India). The seller usually provides the bill of lading or other receipt from the shipping agency, which indicates that goods have been handed over to the agent of the buyer. Thereafter the buyer assumes the risk, and liability of insurance and transportation charges. The bill of lading, therefore, indicates that the goods have been delivered and sale complete and thereafter the property vests in the buyer. The sale in that case is made in England. The shipping agency is the agent of the purchaser. Where in pursuance of an agreement, the seller delivers the goods to the buyer or to a carrier or other bailee whether named by the buyer or not for the purposes of transmission to the buyer and does not reserve the right of disposal, he is deemed to have unconditionally appropriated the goods to the contract. The buyer's assent to the passing of the property in the said circumstances is implied and, when the seller dispatches the goods and delivers them to the common carrier for purposes of transit to the buyer, the common carrier not only receives the goods as agent of the buyer but also assents to the appropriation made by the seller [*see Mahabir Commercial Co. Ltd. v. CIT* [1972] [86 ITR 417](#) (SC)].

In *Addl. CIT v. Skoda Export* [1988] [172 ITR 358](#) (AP), an agreement related to delivery of machinery and equipment to FOB European port, the time for fulfilment of delivery was the date of bills of lading. The High Court held that the insurance risk during the course of the journey was that of the assessee and it paid for the same and even the freight charges from the European port to the place of destination were paid by him, the sale of machinery was complete outside India. The Tribunal had held that no part of the profit arising therefrom could be said to have arisen in India. The High Court, however, held that the sale of machinery though completed outside India, was not an independent or isolated transaction and that it was part and parcel of the business venture or business connection between the assessee and the non-resident. The question whether the goods, when in transit, could be sold and said delivered on handing over the documents, depends on whether the title to the goods has passed, *i.e.*, the risk and rewards incident to the ownership of the goods no longer remain with the seller, and the seller does not retain any effective control to an extent normally exercised by the owner and any significant act of performance remains to be done. For example, if the seller takes delivery of goods from the ship and makes payment of the customs duty, he cannot be said to have sold the goods and delivered on high seas. Further if documents represent goods and handing them over means their delivery, the place of delivery is the place of handing over. The goods are in transit and cannot be physically delivered, their delivery is effected by handing over the documents relating to them. The place of delivery would be the place where the title to the documents assigned by handing over, because documents are taken to be 'goods-in-transit'. Handing over the documents simpliciter, without assigning title does not result transfer of goods. Such transfer of documents have relevance for maritime claims only.

Sale alone does not determine the place in the modern context - Distributive accrual

1.15 It is a too simplistic concept to say that profits arise where sales take place. The act of sale is only the mode of realization of profits which arise at the place of source. For instance, where a person carries on business of manufacture, sale, export and import, it is not possible to say that the place where profits accrue or arise to him is the place of sale. The profits received firstly from his business as manufacturer, second to his trading operations, and thirdly to his business of import and export. Profits attributable to the manufacturing business are said to arise or accrue at the place where manufacturing is being done and the profits which arise by reason of the sale are said to arise at the place where sales are made and the profits in respect of import and export business are said to arise at the place where business is conducted (*see CIT v. Ahmedbhai Umarbhai & Co.* [1950] SCR 335; [18 ITR 472](#)). It is not the act of sale by which manufacturing profits accrue. The act is only the mode of realizing. Profits from the activity of manufacturing arise at the place where manufacturing is done and from the business of trading where sales are made. Where income accrues is to be determined on the nature of the business activity. Therefore the concept that profits of a business arise only at the place where the sales take place is too simplistic and can no longer hold good particularly in conditions of modern business which involve the extreme skill and expertise at various stages each of which adds to the value of goods or services ultimately supplied - *see AAR No. P - 13 of 1995, In re* decided on 23rd August, 1995. The decisions of the Supreme Court in *CIT v. Ahmedbhai Umarbhai & Co.* [1950] [18 ITR 472](#) (SC) and *Tata Iron & Steel Co. Ltd. v. State of Bihar* [1963] 48 ITR 123 (SC) establish this general principle of distributive accrual. Section 9 of the Income-tax Act, 1961, has given statutory recognition to this principle. Section 9(1)(i) read with *Explanation 1* thereto enacts that, where a non-resident earns income from business the entirety of operations of which is not carried on in India, he will be taxable in India not on the totality of the profits of the business as a whole but only on such part of profits as is reasonably attributable to the operations carried out in India.

Profits from the activity of manufacturing - Location (Operations test)

1.16 As discussed in the preceding paragraph the principle of trading income is not entirely applicable in case of manufacturing income. The source in the case of trading is the property, and the test is contract conclusion test. In the case of manufacturing it is the activity. Income from the activity will arise where the manufacturing takes place and the test is the operations test. This test was first developed in *Smidth v. Greenwood* [1922] 8 TC 193 when Lord Atkin stated, "... the question is, where do the operations take place from which the profits in substance arise ?" It was a case of Danish manufacturer of machinery for cement and brick works, it was not a mere trader. The place of sale is not the determining factor, if there are circumstances that outweigh its importance or unless there are no other circumstances that can. Where sale contracts are made is very important element in the enquiry, and, if

it is the only element, then conclusion of such contracts determines the profits. But this is not decisive in the manufacturing activity. The involved operation from which profits in substance arise is the manufacture of goods. On sale of manufactured goods, what the manufacturer receives is the reward for his activity of manufacturing. The act of sale is the mode of realisation of property from the activity of manufacturing [see *CIT v. Ahmedbhai Umarbhai & Co.* [1950] [18 ITR 472](#) (SC)]. Performance of obligation under a contract is the relevant factor. In that context, the expression effected is to be understood.

Profits from multi-sourced assets or activities (Dominant factor test) Profits from multi-sourced assets or activities (Dominant factor test)

1.17 A source of income may, and commonly does, consist of several factors. The character of the source may depend upon which of them is dominant. The earning of a carpenter who owns his tools, or of a taxi driver who owns his car, is treated as wholly derived from personal exertion, although it is, to a certain extent, derived from property. And there are many forms of income which are regarded as wholly derived from property, notwithstanding the fact that an appreciable amount of personal exertion is involved in connection with the property. Where income is derived from wages or salary, again the source has several factors. Personal exertion may be involved in negotiating and obtaining the contract of employment, in performing the stipulated services, and in obtaining the payment for them. The source of wages may, therefore, consist of three elements of getting the job, doing it, and getting paid for it. Which of the factors most important depends upon the facts of a given case. Thus, if the source of income consists substantially in making the contracts, the place where the contracts are made may be regarded the only significant factor. If it consists in first making the contracts and then carrying them into effect in circumstances such that both elements are substantial factors in the source, an apportionment must be made - *Maclaine & Co. v. Eccott* [1926] AC 424. If the making of the contract is an insignificant factor, the only substantial element is its performance. The place of performance is the only relevant locus of the source. Thus, the source does not mean the geographical source of income but rather nature of income. A person who neither owns anything in a country nor has he done anything in that country cannot derive income from that country.

In determining the source of profits based on various factors, the locality where it could be said arising must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit - *C of T (NSW) v. Hillsdon Watts Ltd.* [1937] 57 CLR 36. The activity or activities which has/have the dominant effect on the taxpayer's profits should be identified and the location of the performance of such activity or activities should be regarded as the location of the source of profits. In case, however, it becomes difficult to determine the dominant factor, the doctrine of apportionment is applied (discussed in para 1.18 below). Courts are generally reluctant to hold that relevant income is multisourced.

In *CIT v. Mitsui Engg. & Ship Building Co. Ltd.* [2003] [259 ITR 248](#) (Delhi), Delhi High Court found that the contract for designing, engineering, manufacturing, shop testing and packing up to f.o.b. port of embarkation could not be split up since the entire contract was to be read together and was for one complete transaction. It was held that it was not possible to apportion the consideration for design on one part and the other activities on the other part. The price paid was the total contract price which covered all the stages involved in the supply of machinery. If there is an instrument of contract which is composite in form, it cannot be separated unless the transaction in truth represents two distinct and separate contracts and is discernible as such (*see State of Madras v. Gannon Dunkerley & Co.* [1958] 29 STC 474 (SC); [1972] 1 SCC 472). Relying on this, the Supreme Court in case of *Bharat Sanchar Nigam Ltd. v. Union of India* [2006] 282 ITR 273 observed :

"The test therefore for composite contracts, other than those mentioned in article 366(29A) (of the Constitution of India) continues to be : did the parties have in mind or intend separate rights arising out of the sale of goods, and if there was no such intention there is no sale even if the contract could be disintegrated. The test, which, for want of better phrase, could be called the dominant nature test, for deciding whether the contract falls into one category or the other is : 'what is the substance of the contract'."

As discussed in paragraph 1.5, the originating cause of income and the location of that cause determine where income arises. If the income has multiple originating causes, the dominant cause is to be determined. The source of income will then be where the dominant cause is located. The courts are reluctant to apportion multiple sources of income but have done in a few cases. In determining the originating cause, the courts have identified mainly two fundamental causes, *i.e.*, the employment of capital and the place of business test. Essentially, the originating cause is either the activities (the business) of the taxpayer or employment of his capital, assets or funds; or both.

Doctrine of apportionment of profits to various localities

1.18 The doctrine of apportionment is also applied where the profit is derived as a result of successive stages of operations, if appointment is possible. It may be possible where income has been derived from mining, processing and selling operations carried out in more than one geographical location - *Commissioner of Taxes v. Kirk* [1900] AC 588.

The application of the principle underlying this decision namely, the principle of apportioning profits as between different processes employed in producing those profits and the different places where they were employed was approved by the Supreme Court in *CIT v. Ahmedbhai Umarbhai & Co.* [1950] SCR 335. It was observed therein by Mahajan J. :

"...For instance, where a person carries on manufacture, sale, export and import, it is not possible to say that the place where the profits accrue to him is the place of sale. The profits received relate firstly to his business as a manufacturer, second to his trading operations, and thirdly to his business of import and export. Profit or loss has to be apportioned between these businesses in a businesslike manner and according to the well established principles of accountancy. In such cases it will be doing no violence to the meaning of the word 'accrue' or 'arise' if the profits attributable to the manufacturing business are said to arise or accrue at the place where the manufacture is being done and the profits which arise by reason of the sale are said to arise at the place where sales are made and the profits in respect of the import and export business are said to arise at the place where business is conducted."

The Supreme Court in *Ishikawajima-Harima Heavy Industries Ltd. v. DIT* [2007] [158 Taxman 259](#) found as a matter of fact "The taxable events in the execution of a contract may arise at several stages in several years. The liability of the parties may also arise at several stages. Obligations under the contract are distinct ones. Supply obligation is distinct and separate from service obligation. Price for each of the component of the contract is separate. Similarly offshore supply and offshore services have separately been dealt with. Prices in each of the segment are also different." On these facts, the Supreme Court observed :

"68. In cases such as this, where different severable parts of the composite contract is performed in different places, the principle of apportionment can be applied, to determine which fiscal jurisdiction can tax that particular part of the transaction. This principle helps determine, where the territorial jurisdiction of a particular state lies, to determine its capacity to tax an event. Applying it to the composite transactions which have some operations in one territory and some in others, is essential to determine the taxability of various operations."

The Court of Appeal in *CIR v. Hong Kong & Whampoa Dock Co. Ltd.* [1960] 1 HKTC 85 said :—

"If it is possible to ascertain how much of the profit is obtained although in an unrealised form at successive stages of the operations, the sum realised may be dissected and separate parts of it attributed accordingly to the places where the respective stages of the operations are completed. If this cannot be done and the total profit recovered is an inseparable whole obtained as an indiscriminate result of the entirety of the operations, the locality where it arises must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit."

In *CIR v. Hang Seng Bank Ltd.* [1990] STC 733, the Privy Council held :—

"There may, of course, be cases where the gross profit derived from an individual transaction will have arisen or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case, in the absence of a specific provisions in the ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong."

Relying upon the said decision of the Privy Council, the Chancery Division of the High Court in England concluded in *Yates v. GCA International Ltd.* [1991] STC 157 that it was possible to regard remuneration from a contract with an international complexion as producing income which arises partly in one country and partly in another. The doctrine or apportionment is based on the principle that the activities carried out overseas give any "added value" to the goods ultimately sold. The profit referable to such value addition can be said to have arisen in the locality where it is done. This principle seems to have been considered by the High Court of Australia in *FCT v. W. Angliss & Co. Pty. Ltd.* [1931] 46 CLR 417 and *D & W Murray Ltd. v. C of T (WA)* [1929] 42 CLR 332. Value

addition is discernible in production/manufacturing as in *Kirk's* case or in case of services as in the *Yates'* case. If it is not so and the total profit recovered is an inseparable whole obtained as the indiscriminate result of the entirety of the operations, the locality where it arises must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit.

The Indian Income-tax Act, 1961, recognises the doctrine of apportionment of profit. Section 9(1) and the *Explanation* thereunder provided that where all operations of a business connection in India are not carried out in India, only such part of the income as is reasonably attributable to the operations carried out in India is deemed to arise or accrue in India. The only exceptions are the operations confined to the purchase of goods in India for the purpose of export or to the shooting of any cinematograph film in India (under certain stated conditions) or the activities confined to the collection of news and views in India for transmission outside India.

Profits from activity of rendering service

1.19 In many cases, a taxpayer does not buy and sell goods, but undertakes activity to earn profit, such as rendering service as a broker or agent. In that case he does not deal with goods as an owner. The source is not the property but the activity. The provider of service earns profit from activity. The place where such activity is performed decides place of profit therefrom. In *CIR v. International Wood Products* [1971] 1 HKTC 551, a taxpayer a Hong Kong company acted as an agent for the overseas sale of Philippines logs. Sales were made through sub-agents overseas, on Commission. The profits were held to be arising outside Hong Kong. In another Hong Kong case, it was found that salvage operation was performed outside Hong Kong. The source of income was held to be falling outside Hong Kong *CIR v. Hong Kong and Whampoa Dock Co. Ltd.* [1960] 1 HKTC 85 (CA).

Rendering service connotes some positive action on the part of the renderer and not a state of passivity. Generally, service income is derived from performance. Where such services are performed is the place where income arises. However, where the service income is not dependent on the services performed, the place where the contract is framed would be more relevant in determining the source of income - *FC of T v. Mitchum* [1965] 13 ATD 497.

A reading of section 9(1)(vi) and (vii) of the Indian Income-tax Act may apparently suggest that Indian Income-tax Act, income is deemed to arise in India if the services are utilised in India, irrespective of the place where these are rendered. It is not the place where the services are rendered. It is where these are utilised [see *Steffen, Robertson & Kristen Consulting Engineers & Scientists v. CIT* [1997] 98 Taxman 598 (AAR- New Delhi)].

The Supreme Court in *Ishikawajima-Harima Heavy Industries Ltd. v. DIT* [2007] [158 Taxman 259](#), however, read that provision as requiring fulfilment of two conditions : "services, which are source of income sought to be taxed in India must be (i) utilized in India, and (ii) rendered in India". Both the conditions must have to be satisfied simultaneously. The Supreme Court held that for a non-resident to be taxed on income from services, such a service needs to be rendered within India, and has to be part of a business or profession carried by such person in India and that "The petitioners in the present case have provided services to persons resident in India, and though the same have been used here, it has not been rendered in India." The Act has now been amended with retrospective effect offsetting the effect of this decision.

Profits from e-Business

1.20 The guiding principle for the determination of the source of income and location of the gross profit *i.e.*, "one looks to see what the taxpayer has done to earn the profit", suits to transaction relating to tangible goods. Even there it has to be modified according to the demands of the situation, nature of the transaction or business. Not only has one to look what the taxpayer has done, one has to find where. The question "where" has acquired greater importance than "what", in the present context of revolution in communication and the electronic commerce or business (E-commerce or E-business). It is very difficult to locate "where" with respect to intangible goods especially digital goods, such as, software, electronic media and information, and, services, such as, ticketing, reservations, consultancy, financial services. The aforesaid guideline has therefore, limited application. In the modern context of internet commerce or electronic commerce (E-commerce) - exchange of goods or services for value on the internet, some other devices have to be invented not only with respect of preventing tax fraud but also sharing tax between different tax jurisdictions. The source-based taxation has lost its rationale and rendered obsolete by E-commerce. The concept of "permanent establishment" in that as defined in relation to traditional way of doing business is becoming less relevant, as the E-commerce does not recognise geographical boundries. The concept is heading towards residence based taxation. In that context, double taxation agreements would lose relevance. But this would not so to be. The spheres of business and the electronic business are presently well

defined, though the latter is carved out of the former. The former deals with goods and merchandise *i.e.*, tangibles; while the latter, with digital goods which could be translated in the language of e-commerce *i.e.*, zeros and ones, bits and bytes. For trade, we need access, communication, processing, and, delivery. The internet technology facilitates the first three layers. About delivery, it could help if the goods could be deciphered into the language it understands. Tangible goods or merchandise cannot thus be translated. Only goods which could be so done are those which are capable of online delivery. Such goods are known as digital goods. Example of these are: software, data and information product, audio and video composition etc. As discussed earlier, in case of tangible goods and merchandise gross profits arise where these goods are delivered. Access, communication or processing have no relevance. The "source" concept is still relevant. As regards, digital goods which are capable of being online delivered, the matter is discussed in the following paragraphs.

Manner of doing business electronically is different from doing it traditionally because of intangibility and anonymity. Traditional commerce is characterised by the materiality of the goods while electronic commerce by immateriality such as software data information product, audio or video compositing etc. Anonymity is another distinct feature. Electronic commerce allows and facilitates commerce independently of physical identity and location of the transacting parties.

Doing E-commerce and E-business

1.21 Electronic commerce may be defined as those commercial transactions carried out using electronic means, in which goods or services are delivered either electronically or tangibly. In other words, it consists in the development of commercial activity by electronic means. It includes (a) variety of activities (*e.g.*, on line sale of goods and services); (b) product (*e.g.*, consumer products); and (c) services (*e.g.*, legal or medical advice). It may simply be referred to commercial transactions in which the order is placed electronically and the goods and services are delivered in tangible or electronic (digitised) form.

Internet commerce of the e-commerce is the exchange of goods or services for value on the internet the selling of the products and services on the internet. It is online shopping. E-commerce is basically of two kinds :

- Indirect e-commerce (electronic ordering of tangible goods); and,
- Direct e-commerce (exchange of intangible goods on-line or using electronic means).

Indirect e-commerce involves ordering of tangible goods. Delivery of such goods cannot be done on line. As aforesaid soliciting customers and orders do not mean doing business within a country and there could not be any question of profit arising in that country. Direct e-commerce involves online delivery, which is possible only if the goods are intangible and digitised.

E-business relates to transforming key business processes by using internet technologies, such as internet processing, e-mail and web browsing. It is about a new way of doing business. It is an extension of the current means of doing business. The involved processes in doing a business are; access, communication, processing and delivery.

The buyer and the seller should have access to each other. Internet commerce attempts to increase the access through the ubiquitous net. The seller has the access through the web browser to the consumer. As for communication, e-mail provides it cheap and easy. At the processing end a number for technologies are at work. It is done through web browsing. Thus, the internet increases the access (through ubiquitous internet) and simplify the access (through the web browsing) to the consumer, enabling him to do business from anywhere. E-mail is the mode of communication.

Internet consists of thousands of linked networks. It is a web, with no centre. The website is a packages of databases, and a website server contained the information required to process the order. The internet obviated the need of physical goods and services in the chain of distribution. The disk and the requisite information can be sighted anywhere. The internet eliminated the need of the people to be physically present in one place rather than the other. In a simple purchase of goods through internet through a mail order catalogue the internet cuts out the middlemen. Whether one just wants to buy and sell, connecting with customers, with sales people, with suppliers or with each other, one can do business over the internet. Such activities were being undertaken earlier also. The means and manner have now changed. Physical presence of the person is not necessary. The middle man is not necessary. Maintenance of warehouses or store rooms are not necessary. Access, communication and processing have become fast and cheap. E-business is an extension of the current means of doing business. The activities of the persons engaged in it are equivalent to soliciting of orders from customers from another country, without doing

any other activity there. Mere soliciting orders or customers does not mean doing business within that country, even before. The crux of the trade still remains the same as before. Where the gross profit from a transaction has arisen, is the question. It is where the sale has been effected. The manner of doing e-business and doing it cheaply and fast has not altered the question. The concept of permanent establishment is still relevant, as it relates to goods and merchandise only. Such goods or merchandise are incapable of on line delivery. As regards digital goods the matter requires some discussion.

E-commerce - Source rule

1.21A As already discussed, income is sourced at the origin of the income, or source of the income generating activity. The source rules for various types of income is not uniform. For every type of income *viz.*, as derived from sales, rentals, royalties or services, the criterion is different. This principle also applies to electronic transactions and well illustrated by the example of software. A computer programme is a set of statement or instructions to be used in a computer in order to bring about a certain result. US Treasury Department has issued regulations regarding transactions involving computer software. They are divided into four categories :

- (1) *Transfer of copyright in the computer software* - Transactions in this category are characterised as sale or licence. The transferee has the right to copy the software for distribution to public and the right to use the underlying code to create derivative programme. Thus, the transferee has received substantially all rights in the software or in a geographic area.
- (2) *Transfer of a copy of the programme* - It consists of transfer of a copy of the programme, copyrighted article rather than of the copyright itself. The user does not have the right to redistribute or create derivative works.
- (3) *Provision of services for the development and modification of the computer programme* - It consists writing programme code for the recipient where the recipient would own the substantive copyrights and assume the risk that the resulting code would serve its purpose.
- (4) *Provision of know-how or the development and modification of the programme* - It involves the transfer of trade secret, where the know-how provider assumes the risk that it has provided the user with something that will achieve the desired result.

Transfer of copyright is a licence or sale. It is licence when payments are made in exchange for a transfer less than all of the rights to the software. These are viewed as royalties. The source rules as applicable to royalties are applicable. It is Indian sourced, if royalties are paid by the Government or the Indian resident or the non-resident PE in India.

If it is outright alienation of rights in software, it is a sale of copyright, as a sale of an intangible property. The second category is a sale of a product, as a tangible property. Both are sourced under the same rules as other property rights. Income arising from such a transaction by a non-resident of a country is sourced outside, unless the sale is attributed to PE in, that country.

As for the third category, a transaction would be classified as provision of services when the transferor/purchaser pays for the services rendered even if such rendering does not yield the desired or the anticipated results. The risk is of the transferor/purchaser. The source is the place of performance of such services. As for the fourth category, it is the place where the know-how is utilised.

E-business, sale of digital goods

1.22 For taxability of income arising from business done electronically, it is necessarily to be found out whether the subject-matter of business is tangible or intangible goods. If the goods are shipped from abroad in consequence of an order placed by mail or telephone, income is not taxable in the import country. Order placed electronically makes no difference. In case of intangible goods, difficulty would arise as to the jurisdiction of taxability.

The issue could be discussed :

- sale of tangible goods over the internet;
- provision of service over the internet;
- sale of digitised product over the internet.

As for sale of tangible goods, there is no difference between the sale by conventional or electronic means. The manufacturer is not taxable in the country of the customer. The taxability for provision of service or sale of digitised product depends upon its nature, *i.e.*, its characterisation. India follows the common concepts of

international taxation : (a) permanent establishment (PE) and, (b) source of income. Conventional commerce is commonly carried through identifiable physical locations which are termed in international taxation as PE. But in electronic commerce, it is not so. Business by electronic commerce is conducted through computers and telecommunication network. The concept of PE is discussed in Chapter 11.

As for services, it can be received over the internet from outside a jurisdiction by accessing or downloading the information required. When a person pays for it, the question is whether the source is in that jurisdiction. It depends on the nature of the services ; whether it could be characterised as income from trade in services or as royalties.

For a business that sells goods or merchandise, the technique of e-business becomes irrelevant because of its incapacity of delivering such goods or merchandise on line. But for a business that sells information instead of goods, a computer server might be considered a warehouse. The issue is discussed later in the chapter dealing with permanent establishment.

E-business - Ottawa Taxation Framework Conditions

1.22-1 The Committee on Fiscal Affairs of the OECD has developed Taxation Framework Conditions setting forth the governing principles in relation to taxation issues related to electronic commerce. These were welcomed by the Ministers at the Ministerial, level Conference on electronic commerce held in Ottawa in October, 1998, "A Borderless World - Realising the Potential of Electronic Commerce". The salient features of the report are :—

1. The same principles that Governments apply to taxation of conventional commerce should equally apply to e-commerce, namely : neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility,
2. These principles can be applied through existing tax rules,
3. The technologies underlying the e-commerce offer significant opportunities for improved taxpayer services, which Government should actively pursue, and
4. The process of implementing these principles should involve an intensified dialogue with business, and non-business taxpayer groups, and with the non-OECD member economies.

To implement the Framework Conditions, the Committee on Fiscal Affairs has set up Technical Advisory Groups (TAGs) which consist of representatives from business, from the OECD and from non-member Governments. These groups are charged with developing ideas and options which will form the basis for policy proposals by the OECD. Five TAGs have been established covering Income Characterisation, Business Profits, Consumption Tax, Technology and Professional Data Assessment.

The Framework Conditions are widely accepted as a sound basis for developing a consensus on the treatment of taxation issues raised by e-commerce. It addresses four areas: tax treaties, consumption taxes, tax administration, and taxpayer service.

In the tax treaty area the framework provides that the present international norms are capable of being applied to e-commerce, but some clarifications should be given as to how these norms, and in particular the Model Tax Convention, applies.

Besides setting forth governing principles, the Committee has specified a detailed work programme, to study and then decide upon implementation options that have been listed with respect to the subjects covered by the agreed Framework Conditions.

As for the international direct tax issues, the work programme centres on the monitoring of the

- application of the current rules for taxing business profits,
- characterisation of payments from different e-commerce transactions for taxation purposes,

as well as longer term work on the future of the concept of permanent establishment.

Two drafts were issued in October 1999 and March 2000 for public comments on the issue of the application of the existing permanent establishment rules under the tax treaties in the e-commerce context. The permanent establishment concept is the central element in determining the taxation rights under tax treaties. It is defined in the OECD Model Tax Convention as, essentially, a "fixed place of business through which the business of an enterprise is wholly or partly carried on." The main question is whether a website or a server can constitute a permanent establishment giving rise to tax jurisdiction in a country.

The other issue which is of great importance is how payments of different categories of e-commerce related transactions are characterised for tax treaty purposes, *i.e.*, how payments for digitised products should be characterised. Two drafts for comments were issued on this question (March and September 2000). The September draft presents an analysis of various characterisation issues and examples of 27 categories of typical transactions. The issue is further discussed in Chapter 5. A report on E-commerce: Implementing the Ottawa Taxation Framework Conditions is given in the appendix to this chapter.

E-business, "bit tax" E-business, bittax

1.23 Taxing e-business is a difficult task. For such a business, it is a borderless world of cyberspace. Most internet transactions occur on website on the internet. While the internet in itself has no physical presence or location, the website is viewable and accessible from a computer from which information can be downloaded. Further e-business would facilitate tax fraud and money laundering. E-cash is a perfect electronic substitute for conventional paper currency is another issue which requires tackling. While many proposals have been suggested to tax the internet, the foremost amongst them is the one suggested a Canadian economist, Arthur J. Cordell, in 1994. It is known as "bit tax". The aim is to generate tax revenues from the value added interactive digital services that are fast replacing traditional forms of commerce in economies globally. It is not of the nature of income-tax. It is only revenue raising device. The speed of information transmission over a network like the internet is measured in bits per second. The bit tax aims to charge a minuscule tax per bit of information that flows through telecommunication lines. The tax would be flat, per unit tax which would not evaluate the use or value of the bit of information. It would tax all bits uniformly.

E-commerce - Place where income from trading arises E-commerce - Place where income from trading arises

1.24 As discussed in paragraph 1.9, the location of the profit from the business of trading is where the contract of purchase and sale effected, from manufacturing where the manufacturing is done, and from rendering services where services are rendered. The principle is not different when the business is done electronically. Law does not differentiate between transactions conducted in physical commerce and the transactions conducted through electronic commerce. There are no rules which differentiate between offer and acceptance for a sale transmitted over the internet and as done through documents or telephone. Similarly software sold over the internet is treated in the same way as the sale in a store.

The two important tests to determine whether the trading profits could be said arising are :

- (1) the place where contract of sales are made,
- (2) place of operations from which profits arise

These tests are relevant for determination the source-based taxation. If a resident of a country exports goods to a buyer in other country, no tax is liable. Any cross border sales are treated exportation of goods. The income is regarded as having its source outside that other country. The source would be in that country, if the vendor has its PE there. It means there is no exportation; the sale is made in that jurisdiction, *i.e.*, sale is effected not outside but in the country. It is therefore necessary to find out where the sale contract is effected.

A non-resident will not be subject to tax in respect of business income which is not attributable to the PE. With respect to electronic commerce a non-resident who does not have identifiable location of business but merely solicits orders from a jurisdiction only through a website and then sends tangible goods in fulfilment of the order is unlikely to be regarded as operating a PE.

E-commerce - Place of contract E-commerce - Place of contract

1.24-1 The place of contract determines the place of arising of income and hence the tax liability. If the place of contract is within India, liability to tax arises here, irrespective of whether significant activities to fulfil the contract are carried out abroad (*see Maclaine & Co. v. Eccott* 10 TC 481) ; the trade is exercised or carried on a place where the contracts are made. Contracts are made where acceptance of offer is communicated.

E-commerce - Formation of contract E-commerce - Formation of contract

1.24-2 Income arises where the contract is formed. It is formed where the acceptance reaches the offering person (*see Bhagwandas Goverdhandas Kedia v. G. Parshottamdas & Co.* AIR 1966 SC 543), which would presumably be the jurisdiction from which the offer was made. Acceptance is incomplete until received by the offeror.

In *Entores Ltd. v. Miles Far East Corporation* (1955) 2 QB 371 [affirmed by the House of Lords in *Brinkibon v. Stahag Stahl und Stahlwarenhand-dels-gesellschaft mbH* (1983) 2 AC 34] British and Dutch parties were in the habit of forming contracts by way of telex service. The British party (the offeror) alleged that the Dutch party (the offeree) had breached the contract. In order to bring proceedings against the Dutch party in the UK, the British party needed to establish that the contract was made in England. The Dutch party contended that it had accepted the offer in Holland, but the Court held that acceptance was not affected until it was received by the offeror in England and that the contract had accordingly been made in England.

Applying this principle in the context of electronic commerce, the contract concluded over the internet is made where acceptance is received in electronic form, by the offeror.

The issue involved whether there is an offer or merely an invitation to treat, and whether communication of offer and communication of acceptance are instantaneous or non-instantaneous.

E-commerce - Offer or invitation to treat

1.24-3 The question whether the information on the website is an offer or advertisement or invitation of treat. There is a distinction between offer and "invitation to treat" or an invitation to bid. An invitation to treat indicates the potential willingness to enter into contract but does not constitute an offer. The web site only displays the product without more definite terms of contract. Product display added with price and terms of delivery may be considered an offer. If a customer only responds to general information provided on a web page, the internet site might be considered no more than a form of advertising or an invitation to treat. It is not the solicitation of orders. Solicitation means that orders must be actually sought out and active attempts made to obtain the business [see *Sudden Valley Inc. v. The Queen* 76 DTC 6178 (FCTD)]. If the presentation is detailed containing information about the description of the product, its pricing and shipping information etc., that presentation is not advertisement or invitation to treat but an offer.

"Advertisement" means to make something known to the public or segment of public, to announce publicly by a printed notice or broadcast to call public attention to, especially, by emphasizing, desirable qualities so as to arise a desire to buy and patronize..... An advertisement is generally of goods and services and is an information intended for potential customers." (see *Google Online India P. Ltd., In re* [2006] 280 ITR 211 (AAR). After quoting Supreme Court in *ICICI Bank v. Municipal Corporation of Greater Bombay* [2005] 6 Scale 110 (wherein it was held that whether a particular action is an advertisement or not would depend on whether the person wants to promote his product or service, the Authority for Advance Ruling observed, "If by any communication, the communicator tries to influence people to buy his product or service or attract towards his product or service then it would be a guiding factor to identify whether a particular communication of the communicator is tantamount to advertisement."

E-commerce - Offer and acceptance communication whether instantaneous

1.24-4 Communication of offer and communication of acceptance may be instantaneous or non-instantaneous. In case of instantaneous, the location would be found to rest with the party which initiated the offer, as in telegraph instantaneous communication. In the case of *Entores Ltd. v. Miles Far East Corporation* (1955) 2 QB 327 it was held that the place of contract is the place where acceptance is received which would presumably be the jurisdiction from which the offer was made. The instantaneous is like a face-to-face communication. The instance of non-instantaneous means of communication is the post, where the postal authority is the agent of the offerer. In that case contract is deemed to occur at the time and place where the letter is posted [see *Imperial Life Assurance Co. of Canada v. Colmenares* (1967) SCR 443]. In the case of instantaneous means of communication, e.g., telex, it is the place where acceptance telex is received.

Before it is discussed whether communication on internet is instantaneous or non-instantaneous, it is necessary to understand the mechanism of contract forming electronically and the legal enforceability thereof.

Conclusion of contract by electronic means

1.24-5 Making of contract, as discussed above, refers to its formation on the acceptance of an offer, leading to the question of concerning the time and place of acceptance in an electronic context. The Indian Information Technology Act, 2000 deals with the question about the time and place of the contract.

Conclusion of contract by electronic means is a new concept. It is not a paper document. If electronic contract is enforceable in law, it is as good as a paper contract. An agreement is enforceable if proposal is offered by one, and

accepted by another, for a consideration. Offer and acceptance are the important ingredients. The manner and means of communication are not important. Any means can be adopted. Electronic communication may achieve the same degree of legal certainty as a paper communication. It has been well recognised world over and now formally recognised in India in the Information Technology Act, 2000. That Act is a commercial code of e-business transactions, containing provisions dealing with, among others, how a contract can be formed electronically. It does not amend the Indian Contract Act, 1872, as regards the legal requirement for the formation of a valid contract. It only provides a legal certainty as to the conclusion of contracts by electronic means. It deals not only with the formation of the contract, but also with the form in which an offer and acceptance are communicated electronically.

Section 13 of the Information Technology Act deals with determination of the time of dispatch and receipt of the electronic record (it is data received or sent in an electronic form), and also the place. Despatch refers to the commencement of the electronic transmission of the electronic record. As regards time, it occurs when the electronic record enters a computer resource (it means computer, computer system, computer network), outside the control of the originator. Receipt similarly occurs at the time when the electronic record enters the computer resource of the addressee if designated ; and if not designated, when he retrieves. As regards place, it is the place of business of the originator (place of despatch) and of the addressee (place of receipt) [section 13(3) of the Information Technology Act].

Thus, the time and place of the despatch and receipt of the electronic record are determined by the entry of the electronic record into an information system. An information enters when it becomes available for processing within the information system. It is irrespective of whether the information is intelligible or usable by the addressee, in the same manner when the paper message is received which may not be intelligible or usable by the recipient. The emphasis is on the word "entry". A message after having reached but failed to enter the information system of the addressee because of any reason, cannot be said to have been despatched or received.

E-commerce - electronic offer and acceptance whether instantaneous and place of contract

1.24-6 Time of the despatch of the electronic message leaving the computer resource outside the control of the despatcher may not coincide the time of its entry to the computer resource of the recipient. Despatch and entry may not be coincidental or simultaneous. Internet communication is therefore is non-instantaneous means of communication.

Thus, if non-resident caused a website (a set of web documents belonging to a particular organisation) to display an invitation to treat which caused Indian customers to make an offer to the non-resident and then the operator of the website sent messages to such customers confirming acceptance that ought to fix the place of contract in India. The contract is made in India when the acceptance is received by the Indian customer.

Place of operations from which profits arise

1.24-7 The other test to decide the place of profit is the place of operation from which it arises. There are many factors which contribute to the profit making process, other than the place of contract, which are recognised in determining the situs of business. Therefore, the Indian Income-tax Act provides that in case of a business of which all the operations are not carried out in India, the income which is deemed to arise in India shall be the only such part of the income as is reasonably attributable to the operations carried out in India [see *Explanation (a)* before section 9(1)]. The key elements in doing business which may decide the location of commercial events, besides formation of contract, are :

- (1) solicitation of orders or the offering of anything for sale and receipt of orders ;
- (2) delivery; and,
- (3) payment.

Solicitation of orders

1.24-8 Solicitation means that order is actually sought out and active attempts are made to obtain business [see *Sudden Valley Inc. v. The Queen* 76 DTC 6178 (FCTD)]. Soliciting orders means that the orders must be sought and attempts made. It is the stage of advertising and convincing the potential customer about the product, and nothing more. It is not an offer, as it lacks the terms of delivery and other details. If a potential customer decides, he may offer to purchase on the said terms. An acceptance as conveyed when reaches to the customer, will result in binding contract. Formation of a contract is all relevant, which conveys acceptance of the offer of orders and in

consequence of which delivery is effected and payment received. Making of contract refers to its formation on the acceptance of an offer (discussed above).

Delivery of goods

1.24-9 The other factor which determines where income arises is the delivery. A good is said to be delivered when the risk of loss and other commercial risks are of the purchaser. Title, therefore, passes at the place where and the time when burdens and benefits of the ownership of property pass to the acquirer. The question where and when the delivery of digital goods, such as software product if carried on tangible media, is made depends on when the said burdens and benefits pass to the purchaser. In other cases, it passes where the said risks of loss become the liability of the purchaser (as is the case of shipping of goods).

In the case of electronic delivery, transfer is not accompanied by the usual indicia of the transfer of title and so it is difficult to apply the "location" concept, *i.e.*, where title passes on passing of the risks of loss. The location of transfer depends on the agreement of the parties, which may either be the location of either. The terms of delivery has, therefore, to be decided. It may be decided that the digital information is delivered at the customer's computer ; or decided that that the customer may draw it from the vender's location. The vendor's website is like a warehouse of digital goods; the vendor may "push" the goods to the customer or the customer may "pull" it from the vendor. Delivery in the former case takes place at the site of the customer, while in the latter, at the vendor's. In the former the delivery is initiated by the vendor, while in the latter, by the customer.

Place of payment

1.24-10 In some case the place of payment is pivotal [*see Wilcock v. Pinto & Co. (1925) 1 KB 30*]. Source of payment taken to be the place, in some jurisdiction, rather the source of production of income. In that case, the location of the payer determines the source of income. For example, royalty income payable by a resident in India is deemed to arise in India [*see section 9(1)(vi) of the Indian Income tax Act, 1961*]. The location of the payer determines the source of royalty income paid to a non-resident. The exception is the royalty payable in respect of right, property or information used or services utilised for the purposes of a business or profession carried on by him outside India or for the purposes of making any income from source outside India. It is because the productive activity is exclusively exercised outside India.

Place of business - Summing up

1.24-11 The key events of a transactions are ; receipt of an order, formation of contract, delivery, and, payment. All are relevant for determining the situs. These could be said to occur :

- receipt of the order occurs in which the server hosting the website is located ;
- contract is formed in the country where the acceptance is received by the offeror;
- delivery occurs where the customer is responsible for importation and bears the risk of loss during transit;
- payment occurs where the payment is received.

The event of placing an order has to be seen in the context whether the information hosted on the website is an invitation to treat or whether it is fully detailed about the terms of contract and delivery. In the former case, it is not an offer ; while it is in the latter. An Indian resident placing an order on invitation only means an offer. The contract of sale shall be complete when he receives the acceptance and when received, the place of forming is in India.

E-commerce - Place where income from rendering of services arises

1.25 As discussed in paragraph 1.9, income from services arises where it is rendered. The word "render" in that context means "to do" or "performed". Place of performance is the place where income from service arises. Only in case where income is not dependent on performance, the place where the contract is formed would be relevant. Services performed or rendered in a country means that the activity relating to the performance or rendering must be done in that country, which would entail the physical presence in that country of the provider.

There is distinction between services provided (such as banking, advertising, transportation, insurance, communication, data processing etc. (*see paragraphs 11-21*) and services performed (such as by a professional and technical person). One is referred to as material services and the other professional. Material services are traded as goods and tend to intensively use technology and capital. The material service is commercial in character in which something is brought into existence quite apart from the benefit of particular individuals. Where there is a

systematic activity organised by the cooperation between the employer and the employee for production of goods and services calculated to satisfy human wants and wishes is a material service because the focus is functional.

The two general criteria are applied:

- (1) physical location of the service provider;
- (2) location of the payer

A third criterion is also applied, *i.e.*, where the services are enjoyed or utilised.

Most countries follow the first, on the principle that income arises where capital and labour input contribute to the production of service.

Place of service is the location of service provider

1.25-1 The principle is the same as for business in goods for determination of place of providing material service. It is based on the principle that taxation ought to be imposed where income economically arises and where the productive economic activity has occurred.

Erichsen v. Last (1881) 8 QBD 414, is an authority for the proposition that a person in the business of providing services does carry on business in a country if he habitually makes contracts there. In respect of professional services, performance is the criterion. Where the services are utilised, is another criterion if the recipient is concerned mainly with obtaining the benefit of the provider's knowledge and expertise.

But where the provision of services is through equipment, *i.e.*, where it is automated in nature, the physical presence concept would be of little assistance. For example, electronic international communication system. In that case, it has to be seen where the productive economic activity has occurred, *i.e.*, where capital and labour inputs that directly contribute to the production of that income are located.

It could be the place where the service provider is located. A case which related to the service provided through equipment will illustrate, as quoted in *Cahiers de droit fiscal international*, Volume LXXXVIa (2001, San Francisco Conference) at page 36:

"In *Piedras Negras Broadcasting Co. v. Commissioner* 43 B.T.A 297 (1941), the taxpayer earned essentially all of its income from the sale of advertising time on a radio station that broadcast from a transmitter in Mexico, just over the border from Texas. Its advertising was clearly targeted towards US listeners, and almost all of its income was earned from advertisers located in the United States. Nevertheless, the court held that the advertising income was foreign source income. Thus, the location of the advertisers and the end-users of the broadcast programs (*i.e.*, the listeners) was not determinative of the source of the advertising income. Rather, the court concluded that the productive activity involved in providing advertising or other services electronically occurs at the place or places where capital and labour inputs that directly contribute to the production of that income are located. While the radio transmitter (analogous to server in the electronic commerce context) was part of the enterprise's productive assets, the court looked to all of the enterprise's labour and capital inputs and not just to the point of transmission."

The location of the service provider is where he renders services. (In case of technical services, it is where utilised.) Where service is rendered, determines the source of income derived from personal services, which would include all services rendered by a non-resident. This principle applies to corporation also. The source is the location of its activity, as for example, in case of advertising (*see Piedras* case above) or sale commission.

In the case of old economy, services income was generated through human labour. The physical location of the service provider was easily identifiable.

This criterion leads to several difficulties, when applied to automatic activities. The difficulty would arise identifying whether the place of performance is that of the location of the server, to what extent are programming, preparatory or administrative activities relevant and how allocation principle would apply when various inputs are involved. By contrast, when characterisation is determined, the second criterion, *viz.*, the location of the payer seems simpler.

Place of service is the place of location of the payer

1.25-2 Some countries follow this criterion that the location of the payer determines the place of service. It is based on the principle that services are normally performed near the location of the recipient. This is a simple criterion

and easy to apply and can be uniformly enforced by withholding at source. But in the case of online booking, this criterion may lead to problems between tax imposed on customer payment to the agency and net income.

Place of service is the place where it is enjoyed

1.25-3 A third criterion is that income is sourced where services are enjoyed, even if the provider is outside the country. Source is the function of the service enjoyed. Section 9(1)(vii) of the Indian Income-tax Act provides for services utilised in India and paid by resident or PE of the non-resident.

E-commerce - Indian Income-tax Act and the source rule

1.26 Income is sourced at the origin of the income (property or asset) or the source of the activity generating income (business or profession). Income is regarded derived from the Indian source if the origin of the source or the income generating activity is in India, *i.e.*, capital or labour which produces income is located in India. However, the source of income by way interest or royalties is determined by the residence of the payer. As for technical services, the location is where utilised.

As discussed in paragraph 1.4, a non-resident is subjected to income accruing or arising from the Indian source. Section 9 of the Indian Income-tax Act, 1961, defines the Indian-source rule as income arising through from any business connection in India, or through or from any property or any asset or source in India, or through the transfer of capital asset situate in India, is taxable in India. Salaries earned in India or dividends paid by an Indian company are also deemed to be of Indian source.

In the above cases the income yielding activity or property exists in India.

There is another category of income which is deemed to be Indian-source, if the payer is the Government or an Indian resident or Indian-business establishment of the non-resident (PE). It is by way of interest, or royalty or fees for technical services. The term "royalty" and "fee for technical services" have been defined for the purpose.

Thus, the source rule depends upon the characterisation of income; whether it is the (a) business activity, or (b) property or asset, or (c) royalties or fees for technical services. Since there is no specific rules relating to income arising from transactions done electronically, the same rule of characterization are to be applied as are applicable to income arising from transactions conventionally done. Item (b) has no relevance here, because transactions relating to them not done electronically. If the transaction is characterised as business activity [item (a)], income is deemed Indian sourced only if there is a business connection, *i.e.*, PE. If it is characterised as royalty or fee for technical services, income is so deemed if the payer is the Government or the Indian resident or the PE of the non-resident. Income arising from electronic transactions needs to be characterised in order to determine which of the Indian source rule is applicable, whether relating to :

- (i) business income, or
- (ii) royalties or fees for technical services.

To determine the issue, it has to be decided, first, whether the "royalties or the fees for technical services" is the source. It is easily determinable, since it is based on the principle of payment by Government or the Indian resident or the Indian PE, with no further analysis. If it could not be so characterised in terms of definitions in section 9(1)(vi) or (vii) of the Income-tax Act, then it is to be done as business income.

E-commerce - Indian Income-tax Act - Royalties

1.26-1 Income by way of "Royalties" is the consideration for the exploitation of the intellectual property right of the recipient and by way of "fees for technical services" is the consideration for rendering any managerial, technical or consultancy services. The "consideration" is for the "use" of intellectual property or for rendering the services. Consideration for the use of the copyright and not for the transfer of the article or product in the manufacture or production of which intellectual property has been used, constitutes royalties. Consideration for the transfer of the copyrighted articles is the business income, which could be said to accrue if there is PE in India. There is no difference between the electronic delivery of products and delivery in a tangible form.

If an electronic commerce transaction amounts to transfer of copyrights, the consideration paid is regarded to have Indian source, if the payer is the Government, or the Indian resident or the PE of the non-resident. If no copyrights are transferred, then it has to be seen whether the source applicable to business income could be applied, *i.e.*, whether PE exists in India or there is business connection.

E-commerce - Indian Income-tax Act - PE or business connectionE-commerce - Indian Income-tax Act - PE or business connection

1.26-2 Characterisation as business income means that income would be taxable in India, if the non-resident has PE in India.

A non-resident is taxable in India on his business income if he is engaged in carrying on business in India. Income arising to him directly or indirectly, through or from any business connection in India, which includes any business activity carried out through a person acting on his behalf to conclude agreements, maintain in India stock of goods or merchandise or habitually secure orders mainly or exclusively for him. Only so much income is taxable as is attributable to the operations carried out in India. He is also taxable, as already discussed, in respect of certain "passive" sources of income, as royalties or technical fees from the intellectual property, the exploitation of which has not reached the stage which could be taken as "carrying on business". These rules are applicable to all types of sources of income, whether derived from electronic or traditional transactions. The position appears to be as follows:

- existing rules do not specifically provide for income derived from electronic transactions;
- there are no specific rules regarding the source of income attributable to functions performed by equipment, as opposed to human beings;
- there is no difference as regards taxability of income derived from conventional or electronic means;
- a sale that is concluded by using the internet is treated in the same way as a sale made with traditional means of communication;
- digitized products downloaded are treated in the same way as goods shipped physically;
- there is no difference whether the goods or products sold are tangible or digitized, income derived from their sale is equally taxable

There are no separate rules for taxation of electronic transactions. In fact, the High Powered Committee appointed by the Government of India in its Report in July 2001 has not recommended any change in the Income-tax Act, 1961 and creating any new rules for electronic commerce (*see* para 1.28-2, below). To do otherwise would have meant preferring one mode of doing business over the other and unequal treatment of business profits. What is taxable is the profits of the business; the manner of doing is irrelevant.

The issue as to whether electronic commerce activities have the consequences in terms of PE (*e.g.*, server or the website) has not been dealt with under the Indian Income-tax Act, 1961. The High Powered Committee made some recommendations in this regard, discussed in the following paragraph.

Taxation of e-business - High Powered Committee ReportTaxation of e-business - High Powered Committee Report

1.26-3 In December 1999, the Government of India appointed a High Powered Committee to examine the position of e-commerce transactions under existing tax laws, to determine changes, if any, required to be made and the implementation of the taxation of those transactions. The Committee submitted its report in July, 2001, made public in September 2001. It has not recommended any changes in the Income-tax Act, 1961, or to the taxation treaties with other countries and has expressed agreement with the basic fundamental principle as laid down by the OECD, *i.e.*, the same principles may be applied to taxation of conventional commerce equally to e-commerce, namely, neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. These principles could be applied through existing tax rules. It has expressly stated that there is no policy justification to exempt net income derived from e-commerce from all direct taxation and that technological neutrality is a fundamental policy point. About characterisation of income, it has expressed its conformity with the views of OECD in respect of certain items, while in respect of others disagreement. Its two important suggestions are :

- (1) The concept of PE should be abandoned and attempt made to find an alternative which could be to tax payments to a foreign enterprise, if it is tax deductible in the hands of the taxpayer in the source country. The tax would be in the form of a low withholding tax, with the option for being taxed on net income.
- (2) There is no rational basis for differential tax treatment for different categories of income and the long-term solution lies in making direct taxation identical for all streams of income, in such a way that there is equitable sharing of revenues between residence and source countries.

The above suggestions are considerably deviated from the accepted pattern of International taxation and the likelihood of their being implemented is doubtful. These are also in direct conflict with the concept of direct taxation, though they may be laudable as regards certainty of tax collection.

An alternative to PE already exists in the Indian Income-tax Act, 1961. It is the "business connection", in section 9. It has now been defined by the Finance Act, 2003, w.e.f. 1-4-2004 in the *Explanation 2* of section 9, which is almost in the same tone as the PE in the OECD/UN model. Earlier it meant a real and intimate relation between the trading activities carried on outside the taxable territories and the trading activities within the taxable territories, the relation between two contributing to the earning of income by the non-resident in his trading activity [see *CIT v. R.D. Aggarwal & Co.* [1965] [56 ITR 20](#) (SC)]. Unless there is an intimate connection between the operations carried in India and the carrying on the business, no income could be said to have arisen in India. Any payment in respect of such operations cannot be subjected to withholding tax, as suggested. This will obliterate the well drawn distinction between doing business with a country or in a country, as brought out in the decision of the House of Lords in *Grainger & Son v. Gough* (1986) AC 325. The case involved a French wine merchant and its UK agent, Grainger & Son would receive orders on behalf of the French wine maker and receive money for the wine. The French merchant would then dispatch the wine to the customer, an act which signified the merchant's acceptance of the customer's order to purchase wine. The risk during transit and the cost of transit was born by the customer. It was held that since the contracts of sale and delivery were made in France, the French merchant was not exercising a trade in the UK merely by seeking others there and arranging for the delivery of merchandise in the UK. Lord Herschell stated :

"In the first place, I think there is a broad distinction between trading with a country and carrying on trade within a country. Many merchants and manufacturers export their goods to all parts of the world, yet I do not suppose anyone would dream of saying that they exercise their trade in every country in which their goods find customers. . . If all that a merchant does in any particular country is to solicit orders, I do not think he can reasonably be said to exercise . . . his trade in that country. What is done there is only ancillary to the exercise of his trade in the country where he buys or makes, stores and sells his goods."

Turnover or the gross receipt cannot be the base of income taxation. What is taxed is the income, *i.e.*, gross receipt *minus* the expenditure. The profit of a business is taxed and not the turnover. However, to check tax evasion or where maintenance of books of account is not possible or there is a difficulty in enforcing their production, device of presumptive taxation is adopted in lieu of the regular framework; there is fixation of income by statutory provisions. It is an estimated tax base applied within the context of regular tax system. Estimated tax base is applied only in case of passive income earned by a non-resident, *i.e.*, interest, dividend and royalties. In such cases there is difficulty in ascertaining expenditure involved in earning the income. Gross amount is the estimated tax base and, therefore, the rate of tax has to be lower than regular rate. The amount of tax is withheld from the payment to the non-resident, which is final. This is done if the activity is not sufficient to reach the threshold of "carrying on business". When that threshold is reached, the income is taxed as business income. There cannot be uniformity of taxation all types of income and also estimating tax base for withholding tax. Uniformity of mode of computation is also not possible. And if applied, distortion and inequity would result. Nature and source defy uniformity. Income from the exploitation of intellectual property right or the passive income as interest or dividend cannot be computed in the same manner as the business income. Differential treatment is inevitable for different nature of income, necessitated by equity and justice. It cannot be obliterated.

As for suggested "base erosion approach", *i.e.* , withholding tax on all tax payments to a foreign enterprise, the Taxation of Electronic Commerce in India by the eComTaxpert Group convened by Nishith Desai Associates, (Published by Taxmann, June 2002), says at page (iv) - (v), as follows :

"In order to avoid an assumed, but unsubstantiated, erosion of the Indian tax base, the HPC (High Powered Committee) has examined the "base erosion approach" as an alternative method to tax e-commerce. This approach is contrary to the international consensus that, withholding taxes are appropriate only in certain limited cases (*e.g.*, on source based interest, royalty, and dividend payments). The base erosion approach is a radical departure from this consensus and is in conflict with the internationally accepted standards on when a jurisdiction has the right to impose an income-tax on a non-resident enterprise. The Group (eComTaxpert Group) cautions that any unilateral move on India's part to adopt such approach may stifle growth of e-commerce in India and may lead to disputes between India and its various treaty partners. Further, in the

formation of its taxation rule, India should also consider the issues relating to the World Trade Organisation (WTO), since it might expose India to indicate issues in relation to the WTO."

About categorisation of income, the High Powered Committee agreed with OECD that characterisation should not change with the mode of delivery from physical to digitised, but disagreed with regard to 13 of the 28 items of transactions, ignoring the principle of neutrality. In deciding categorisation whether it is business or royalty, the TAG of the OECD is of the view that it depends on identification of the consideration for payment: "...where the consideration is for something other than the rights in copyright (such as other types of contractual rights or such as data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on customer's computer or network, such use of copyright should be disregarded in the analysis of the character of the payment for tax purposes." The principle is to identify for what the consideration is paid: "for the use of, or the right to use". If it is for the right in intellectual property, then it is royalties. If it is for other than for that right, it is a purchase for the purpose of the use of the product. This principle appears to have been missed by the High Powered Committee where it expressed disagreement with TAG of the OECD on categorisation of the said 13 items of transactions.

Taxation of e-commerce - two approaches

1.26-4 As regards e-commerce, there are no specific rules, as aforesaid, but the application of the traditional rules may pose problems. The High Powered Committee was appointed to find the solution.

There are two approaches for taxing goods or services related to e-commerce :

- Physical-oriented source rules;
- Legal-oriented source rules.

The tax authorities would prefer the first and the businessmen, the second.

The physical-oriented source rule is based on the place of doing business, place of receiving or consuming service, or on the place of payment. In that case the "place" is determinable as having reference to physical activity, *i.e.*, where business is done or services received or payment made. There is certainty. The legal-oriented source rules include place-of-contracting and the place-of-transfer-of-title. Legal concepts are involved in determination where the offer is made, acceptance conveyed, risks of loss passed etc.

Tax authorities would desire avoiding assessment problems, and administrative cost, and also preventing erosion of the tax basis and would prefer the physical source rule. Businessmen would desire legal certainty, no double taxation, less cost of compliance, and, would prefer taxation in the State of residence of the taxpayer. They would, therefore, prefer legal-oriented sourcing rules.

The High Powered Committee made recommendation from the tax authority's point of view of preferring physical-oriented source rule for e-commerce transitions, *i.e.* , preventing tax erosion base.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - GENESIS

Introduction

2.1 With the increasing industrialisation and of trade, commerce and finance in the recent years, countries in the world cannot remain independent from each other. The interdependence of the countries is so great that any economic imbalance in one country affects the economy in another or rather influences its course. National policies have, therefore, become international oriented, as is normally reflected in tax legislation and practice. It is a well known fact that any change in tax laws of a country has the effect of influencing its trade and economic relations with other countries. The country, therefore, exercises great care and caution in the formulation of its tax laws so as not to endanger its international economic interest.

There can be no dispute that taxation is a deterrent against free flow of trade. As a result of favourable or unfavourable treatment by way of taxation, the flow of trade gets regulated either adversely or favourably. The tax structure can be an important independent factor in determining the growth potential of the economy. It may stimulate or restrain the inflow or outflow of investment funds from or to foreign countries. Taxation laws of a country, therefore, play a significant role in international business relationship. Many international tax angularities are evened out, and many problems are solved or mitigated by bilateral 'treaty' which expression means any international agreement in written form, whether embodied in a single instrument or in two or more related instruments, called either treaty, convention, protocol or covenant, concluded between two or more States governed by the international law. Such treaty is an attempt to invoke the concept of comity of nations or of rules of international law in the interpretation of an agreement that derives legal sanctity from the country's own income-tax law.

Double taxation agreement - Interaction of two systems

2.2 Double tax treaties comprise agreements between two countries, which, by eliminating international double taxation, promote exchange of goods, persons, services, and investment of capital. These are bilateral economic agreements, where the countries concerned evaluate the sacrifices and advantages which the treaty brings for each contracting State, including tax forgone and compensating economic advantage. The interaction of two tax systems each belonging to different country, can result in double taxation. Every country seeks to tax the income generated within its territory on the basis of one or more connecting factors such as location of the source, residence of the taxable entity, maintenance of a permanent establishment, and so on. A country might choose to emphasise one or the other of the aforesaid factors for exercising fiscal jurisdiction to tax the entity. Depending on which of the factors is considered to be the connecting factor in different countries, the same income of the same entity might become liable to taxation in different countries. Thus, double taxation occurs when two States exercise their right to tax the same person on the same income. This so happens for the following reasons :

- ❑ The States levy taxes on income which has arisen or accrued abroad, in case of their residents.
- ❑ The States do not waive or surrender their right to tax a person on the income which has arisen or accrued in their jurisdiction by virtue of the location of the source.
- ❑ A person is deemed simultaneously to be resident by the two States, in one by virtue of his stay and in the other by virtue of any other criterion such as the source of income, or when the source rules overlap because two States find the same transaction to be within their territory.
- ❑ Certain States tax worldwide income of their citizens, irrespective of their being residents of other States.

Double taxation of the same income in the hands of the same entity would give rise to harsh consequences and impair economic development. In order to avoid such an anomalous and incongruous situation, the Government of different countries enter into bilateral treaties, conventions, or agreements for granting relief against double taxation.

Double taxation agreements between two countries, therefore, aim at eliminating or mitigating the incidence of double taxation. Or where such treaties are not in existence, countries have been avoiding taxing the same income twice through their unilateral action. For developing countries such treaties have further importance as they facilitate attracting foreign investments. Thus, the arrangements between the two countries to ensure that the persons are not taxed twice over, once in one country and again in another, on the same income, have normally been embodied in an agreement called avoidance of double taxation agreement. Such agreements are given statutory force in each country. They override any other enactment. Even the Parliament itself cannot alter the wording of the double taxation agreement without the consent of both the parties.

Double taxation agreement - Objectives

2.3 The object of a double taxation agreement is to provide for the tax claims of two Governments both legitimately interested in taxing a particular source of income either by assigning to one of the two the whole claim or else by prescribing the basis on which the tax claim is to be shared between them—*Ostime (Inspector of Taxes) v. Australian Mutual Provident Society* [1960] 39 ITR 210 (HL).

Double taxation agreements seek to eliminate the double taxation of certain income where a resident of one country derives income from a source in another country and aim to ensure facilitating international trade and

commerce, flow of investments as also equitable collection of revenue. The agreements tend to achieve the aforesaid aims by—

- a. clarifying where a country of source may tax non-resident in respect of certain types of income;
- b. limiting the rate of tax a country of source may apply to certain types of income; and
- c. providing foreign tax credits in the country of residence against taxes paid in that country on income having source in the other country.

The other object of the double tax agreements is to prevent tax avoidance by exchanging information.

Double taxation is avoided in the agreements by allocating taxing rights between the resident and the source countries and by requiring the former to eliminate double taxation where there are competing taxing rights.

Thus double taxation agreement allocates jurisdiction between the Contracting States for the purpose of levy of tax and limits the rate of tax leviable under the agreement. The jurisdiction to tax business income is allocated to the State where the enterprise has the permanent establishment; dividend, interest, and, royalties income to the State of residence of the recipient, while maintaining the jurisdiction of the source state to tax at the specified rates; capital gains to the State where the property is situated. Apart from allocation of jurisdiction, the agreement also helps to resolve problems which cannot be done unilaterally, through the mechanism of Mutual Agreement Procedure and Exchange of Information and Administrative Assistance.

The absence of double tax agreements has the effect of immediately increasing the tax charge on remittances of profits out of foreign countries, in the form of dividends, royalties and interest. All such remittances may suffer a discriminatory level of withholding tax. The remittance if it takes the form of profit from a branch of the head office, is also subjected to tax. A number of countries, viz. France, Canada, Australia, USA levy a branch profit tax to place branches on an equal footing with a subsidiary which would suffer withholding tax on dividend payments. Therefore, most double taxation agreements either eliminate or reduce the risk of double taxation. Besides, they also provide for a reduction in withholding tax rates and provide protection to the overseas residents by means of non-discrimination clause.

Originally, avoidance of double taxation was the purpose of a tax treaty. It has now been extended to prevention of fiscal evasion, non-discrimination, exchange of information.

Double taxation agreement - Pattern of taxation

2.4 Double taxation agreements determine which of the two Contracting States may subject the income to their taxes. Sometimes the right to tax is given to the country where income arises, exclusively or by way of priority. In other cases, the residence country of the recipient of the income has the exclusive right to tax; while in some other the source and residence country may tax the income, in which 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 period or methods specified in the concerned agreement. According to the current practice, there is well established pattern of taxation of various types of income. The agreements provide for allocation of taxing jurisdiction to different contracting parties in respect of different heads of income. Detailed rules are stipulated with regard to taxing of income from immovable property (article 6 of the UN model), business profits (articles 7, 8 and 9), dividends (article 10), interest (article 11), royalties (article 12), capital gains (article 13), income from independent personal services (article 14), dependent personal services (article 15), director's fees (article 16), income of artistes and athletes (article 17), pensions (article 18), government service (article 19), income of students and apprentices (article 20) and other income (article 21). In general, the rules are to the following effect:

- Income from the business is taxed—
 - a. only in the resident a country, if the business undertaking carries on no activity in the source state;
 - b. only in the source state, if there is a fixed place of business, i.e., permanent establishment and to the extent it is attributable to that place;
- Income from immovable property arising to a non-resident is taxed primarily in the state of its location.
- Income from movable property such as dividends, interest or royalty are primarily taxed in the residence state, but the source state may impose a reduced tax.
- Income from personal exertion such as director's fees, service fees, pension, remuneration is taxed according to various rules, with varying solutions.

The "source state" is the state from which payment is made and the "residence state" is the state where the recipient of the payment is taxable.

Source State is where income is physically or economically generated and the residence State where it is habitually or permanently consumed or otherwise utilized, *i.e.*, where the capital owner is the resident. Income may be generated where the product is physically produced, or where utilized (for example, services), or where paid for.

Thus, the primary right of the source country to impose tax on business profit and income from immovable property has been a well accepted principle of all tax agreements. The primacy, however, does not mean exclusivity. In respect of income from movable property (namely, interest, dividends and royalties) and income from shipping, the principle of primacy is not followed. For such income reliance is placed on the principle of granting exclusive right of taxation by the country of residence or by the source country at reduced taxation at source. As a correlative to the right of taxation at source, the treaty imposes obligation upon the source country to ensure that the rates be not so high as to discourage investment and to take into account expenses allocable to the earning of the income so that such income would be taxed on a net basis. Such obligation stems from the appropriateness of a sharing of the revenue with the country providing the capital.

Thus, the residence State is a world wide taxing authority. However, the source State can tax business profits attributable to a source State permanent establishment on a net basis and certain investment income on a gross basis. If the source State is permitted to tax under an applicable treaty, the residence State must relieve double taxation either by granting a tax credit and/or exempting the income taxable in the source State.

Double taxation agreement - Development of model

2.5 The problems relating to double taxation are by and large common, with few of them being peculiar to particular tax situation in a country. To have a model for tax convention (agreement) was thought a desirable necessity so that such model could provide a frame for the drafting of a particular agreement. Although the earliest tax treaty is traced back to the 19th century the direct sense of the OECD (Organisation of European Economic Cooperation and Development, which is a group of 29 developed countries) can be attributed to the activities of the League of Nations. In 1920, the International Chambers of Commerce sought the help of the League of Nations to overcome international double taxation and to promote the recovery of the world trading system. Structuring the model tax treaties were being attempted so that differences of different tax systems of individuals systems of individual countries are reconciled preserving at the same time national sovereignty in tax matter. The model had, therefore, to deal with questions of assignment of tax jurisdiction, sharing of revenues, relief from double taxation, and tie breaking rules as regards residence and also avoidance of tax. Since tax regimes were different uniformity was not possible. But at least there should be some pattern of agreement to act as guidelines, to reconcile the aforesaid conflicting interests. That draft could be modified by the agreeing parties with reference to their peculiar problems.

Model forms for the convention applicable to all countries were first prepared by the Fiscal Committee of the League of Nations in 1927. Later the said Committees conducted meetings in Mexico during 1945 and in London in 1946 and proposed minor variations.

The model conventions were published in Geneva in April 1946, by the Fiscal Committee of the UN Social and Economic Council. Model drafts were prepared by the League of Nations known as Model Treaty of Mexico of 1943 and London Model Treaty of 1946. These drafts were made the starting point by Organisation of European Economic Cooperation (OEEC) and its successor Organisation for Economic Cooperation and Development (OECD) (which is a group of 29 developed countries) in attempting a draft model for the avoidance of double taxation. The draft was published in 1963, which is called the Model Convention of 1963. This model was being used by the developed countries as a basis for concluding bilateral treaties. Based on practical experience, this model was revised in 1974 and 1977. The model was reflective of the standard to be followed. In 1992, a new model was published. This differs in a few respects from 1977 model. The revised model remained substantially the same, though ambulatory. The commentary has been considerably expanded. The model is followed in drafting bilateral agreements, to a great extent, modified only to the extent necessary to cope with the special problems arising from the differing levels of development or differing structures of tax systems of the Contracting States. The OECD provided its own commentaries on the technical expressions and clauses in the model conventions. Lord Radcliffe in *Ostime (Inspector of Taxes) v. Australian Mutual Provident Society* [1960] 39 ITR 210 (HL) has described the language as the international tax language.

The other models, *viz.*, the Andean Model (concluded by member States of the Andean Group, *viz.*, Bolivia, Chile, Ecuador, Colombia, Peru and Venezuela), the UN Model (published by the United Nations in 1980), the US Model (published by the United States in 1981 to serve as the basis for treaty negotiations by the US with others) differ on whether the income be taxed in the country of source or of the residence of the recipient.

The model is concerned with substantive tax laws of the party States. It does not deal with procedural part how the obligation thereunder performed. The performance requires determination of income and determination of tax thereon, according to the domestic laws. Treaties also do not create charge to tax which does not exist under those laws. The first requirement of the model is the substantive part of the compromise, *i.e.*, which State has the right to tax and to what extent. The aforesaid models differ principally on the issue whether the residence State or the source State has the primacy. The OECD Model insists upon the residence State. The UN Model recognises the right of the source State. But both agree about taxing right of the source State of the business income only if the resident of another State has permanent establishment in the source State. It is also recognised that when an income is taxed by source State in accordance with its domestic law, the residence State has to exempt or give credit for the tax paid in the source State. Thus, the models deal with the following :—

- Imposing liability to tax in one country whilst granting exemption in the other;
- Granting exemption from tax in either or both the countries;
- Deeming geographical source provisions for particular categories of income to be in one country rather than in the other;
- Imposing liability to tax in the country in which income is deemed to arise.

Models treat the above issues differently, in most cases, taxpayer's country of residence is entitled to tax the taxpayer on dividend, interest and royalty income but the country of source may impose withholding taxes. The source country may also tax in full the profit of any commercial enterprise which is attributable to "permanent establishment" of the non-resident in that country.

Double taxation agreement - OECD Model Double taxation agreement - OECD Model

2.5-1 The draft models prepared by the League of Nations did not reach the final form until after the World War II in the so called Mexico and London Models with the former generally regarded as favouring source (developing) countries and the latter residence (developed) countries. This work in effect was taken over by the predecessor of the OECD and led to the draft in 1963 that followed the London rather than the Mexico Model. It was following the publication of this draft that the rapid development of the world tax treaty network occurred. By the time that the final OECD model was published in 1977, the development of comprehensive bilateral treaty net work among the members was well advanced. The need for double taxation agreement, as aforesaid, arose because income that arises in one country and then flows to another country, say, business profits, dividends, interest, royalties and so on, is taxed by both countries according to their respective laws resulting in double taxation of international income. Cross-border investment was greatly impeded because of lack of co-ordination between the two taxation regimes. The OECD model tax convention is an attempt at such co-ordination between the "source state" (the state from which the payment is made) and the "residence State" (the State where the recipient of the payment is taxable, usually as a resident or national). Its notable feature is that it emphasised residence over source. Priority to taxation is given to the residence state.

In 1992 a new Model was published. This differs from the 1977 Model but is substantially the same. The Model Convention is now available in loose-leaf format, so that it could be regularly updated. Updates have already been published in 1994, 1995, 1997 and 2000. The text had been translated into more languages. The introduction now better reflects the role played by the Model in negotiations between non-member countries. The requirement that the recipient of royalties must be the beneficial owner was being removed. Minor corrections and changes to the Commentary were being made in Article 1 (personal scope), Article 9 (associated enterprises), Article 15 (dependent personal services), Article 16 (directors' fees), Article 19 (Government service), Article 24 (non-discrimination), Article 25 (mutual agreement procedure). The Model was being cross-referenced to the OECD's work on transfer-pricing guidelines. The 2000 update to the Model Convention (Published in August, 2000) made the following changes :—

- Paragraph 4 of Art. 2 slightly amended;
- Article 3; new definitions of "business" and "enterprise";

- Article 14 deleted; consequential changes to other articles;
- New paragraph 4 added to Article 23A;
- Article 26 extended to cover all taxes.

A new Article 27 on "Assistance in the Collection of taxes" is added to the Model Convention. Countries sharing similar tax systems and administration regardless of the subjective and objective scope of the Model Convention (Articles 1 and 2), will agree to collect taxes or take measures of conservation upon request of the other Contracting State. The Article includes various provisions intended to safeguard taxpayers' rights. The new provision is applicable where tax claims are enforceable and collectible in the requesting State, whose time limits will exceptionally apply also in the requested State. However, no priority is to be given to the tax claim in the requested State and the taxpayer does not enjoy the right to raise in the courts of the requested State any matter relating to the validity or the amount of the claim. Similar to Article on exchange of information, there is no obligation on the requested State to carry out administrative measures that are contrary to either State's laws or administrative practices, or to public policy. The Article will also require that the requesting State has exhausted its own collecting measures and will permit the requested State to assist only if the administrative burden does not clearly exceed the benefits.

The IFA Year Book 2001, gives a summary of the amendments made in the Commentary, at page 44 :

Amendments to the Commentary concern e-commerce (affecting the Commentary on Articles 5 and 12), the interpretation of the definition of the PE, the cases, the clarification of beneficial ownership concept, and the new Article 27. Revision of the interpretation of the definition of PE presents points what should be regarded as a place of business, when it should be regarded as fixed (providing additional clarification of the time requirement), what relation should exist between the place and the enterprise, what is the scope of the rule on construction sites (including where parts of structure are built in different places), the application of the definition with respect to cables and pipelines and the scope of the rules of agency PE. As for the entitlement to treaty benefits, the commentary on Article 1 includes an example of comprehensive LOB clause and the Commentary on Article 23 includes an example of switch-over provision enabling a State that applies the exemption method to adopt the credit method instead, as a response to preferential measures introduced by the other State after the treaty between them was signed. The clarification of the concept of beneficial ownership should now imply that such term is used in respect of Articles 10, 11 and 12 not in the narrow technical sense, but in the light of the object and purpose of avoiding double taxation and preventing tax avoidance and evasions.

Thus, the main amendments concern—

- (i) e-commerce, affecting the Commentary on Articles 5 and 12;
- (ii) the interpretation of the definition of PE ;
- (iii) the addition of examples of provisions restricting entitlement to treaty benefits in some cases;
- (iv) the clarification of the beneficial ownership concept; and
- (v) the new Article 27.

Beginning with the 1997 update, the model is presented in two volumes. Volume 1 includes the introduction, the text of the articles of the model and the commentary thereon. Volume II includes a section of the position of the non-members countries, reprints of 16 previous reports dealing with tax convention that the Committee of Fiscal Affairs has adopted since 1977, the list of tax conventions concluded between member countries and this text of the Council Recommendation on the Model Tax Convention.

Double taxation agreement - UN Model Double taxation agreement - UN Model

2.5-2 The OECD Model was also used in negotiations between the OECD members and non-members, and among non-members so that the OECD Model has had extensive influence far beyond its membership. OECD Model is generally regarded as being geared to the interests of the developed countries. The developing countries felt the need of their own model treaty. This has been supplied through the 1979 UN Model and 1980 and 2001 UN Model. This Model in a sense owes more to the Mexico Model than the London Model. The starting point in drafting the Model was the OECD Model and so there is significant similarity in language between these two Models. The commentary published with the Model, as relevant background material, reproduces a sizeable proportion of the OECD's commentary on the OECD Model.

The salient features of the UN Model are :

1. Prior right of tax on income to the country of its source;
2. Rates of tax which may be withheld from dividends, interest and royalties to be negotiated bilaterally, unlike the OECD Model which specifies the maximum rate (or the exemption in the case of royalties);
3. In the case of shipping profits, the UN Model provides alternative articles, one giving the tax, as in the OECD Model, exclusively to the country in which is situated the shipping operator's place of effective management, and the other providing for the tax to be shared between the country in which the operator's place of effective management is situated, and the country where the operations are carried out.

Double taxation agreement - OECD Model and Andean Model

2.5-3 The Andean Model sticks to the source country principle, while the OECD Model recognises the priority of the country of residence to tax income. The basic concept of the OECD Model is opposed to the principle of source. The approach of this model is to reserve the right to tax income and gains to the country where the taxpayer is the resident, except in cases where he has immovable property or substantial business operations through permanent establishment in the other country.

Since the taxability of income is dependent upon the residential status of the investor, which in the case of developed and developing countries is always in the former because of the flow of investment being unidirectional, *i.e.*, from the developed to the developing countries, and thus confining the taxing rights to the richer countries, the approach of the OECD Model is not to the liking of the developing countries. They want to share a part of tax because the income have arisen in those countries. The Andean Model, therefore, seeks to resolve the basic cause of international double taxation (the differing or overlapping rules for locating the source) by locating the source in one country or the other but never in both in contrast to the OECD Model which resolves it by dividing the tax 'take' between the two countries. In so doing the OECD Model recognises, and the Andean Model ignores, that other rule, known as the *sauce doctrine*, that what is sauce for the goose is sauce for the gander. The Andean Model suggests almost exclusive taxation at the source, with an exception for profits from international traffics. Consequently the model does not use the permanent establishment concept as a decisive criterion for taxing jurisdiction.

Double taxation agreement - OECD Model and UN Model

2.5-4 As the Andean Model is intended to serve the purpose of Andean Group, the UN Model is intended to serve the interests of developing countries, both are alternative to the OECD Model. It was published by the United Nations in 1980 and 2001. The UN Economic and Social Council had recommended in its resolution in 1953 that the principle of source constituted the primary basis of tax agreements between the developed and the developing countries. That source principle governed the field till it was disturbed by the London and the OECD Model. The UN Group re-established the principle of source. The Model gives greater tax rights to the country where income arises by providing for high rates of withholding taxes on dividends, interest, and royalties and by allowing countries to retain most of the taxing powers available under their domestic tax laws for foreign business operating in their country. The UN Model corresponds to the OECD Model; though its contents diverge in some important respects.

Double taxation agreement - OECD Model and US Model

2.5-5 The US Model was first published in 1976, revised in 1977, 1981, 1996 to serve as model for all treaty negotiations by the USA. This model is designed to follow the pattern of the OECD Model as also to adapt some traditional peculiarities of the US treaty practice. Like the OECD Model, the U.S. Model is intended to be ambulatory document that may be updated from time to time to reflect further consideration of various provisions in light of experience, subsequent treaty negotiations, economic, judicial, legislative or regulatory developments in the United States, and changes in the nature or significance of transactions between U.S. and foreign persons. The principal function of the Model is to facilitate negotiations and not provide text that the United States to propose. It could be varied in an individual treaty negotiations.

Double taxation agreement - Between developed and developing countries

2.6 Since many countries do not have their own models, they tend to follow either the OECD Model or the UN Model tailored to the peculiar requirement of the Contracting States or their tax laws. Tax agreements between the developed and developing countries encourage to a considerable extent promotion of the flow of investment of capital or technology for the economic development of the latter and thus are drafted to provide for favourable tax treatment to such investments on the part of the countries of the origin, both by outright tax relief and by measures which would assure to them the full benefit of any tax incentive allowed by the country of investment.

So far as India is concerned bilateral agreement for regulating some of the problems of double taxation began in 1947 when it entered into an agreement for avoidance of double taxation with Pakistan. Thereafter, it has entered into agreements with various countries and has today an extensive network of such agreements. The pattern, which for obvious reasons employs similar forms and similar language in all the agreements, is derived from a set of model clauses proposed by the Fiscal Committee of the League of Nations and by the OECD and finally by the United Nations.

Double taxation agreement - Models lead to development of international tax law

2.7 In view of the standard OECD and UN Models used in all double taxation avoidance agreements, a new era of genuine 'international tax law' (international tax law is the conglomerate of tax treaties in combination with unilateral relief provisions, the study of national tax systems as to similarities and differences) is now in the process of developing. These have served the purpose as expressed by the Secretary General of the UN in the regular session of 1978 of the Economic and Social Council that bilateral tax agreements should be as uniform as possible so as to prepare the way of international tax agreements. Any person interpreting a tax agreement must now consider decisions and rulings world wide relating to these agreements. The maintenance of uniformity in the interpretation of a rule after its international adaption is just as important as the initial removal of divergencies—*Corstar v. Eurymedon* [1938] 1 All ER 122 (CA). Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant—*CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP).

For the efficient and fair application of tax agreement attempt of the courts world over should be to interpret its provisions consistently avoiding collision.

Inconsistencies in the decisions may result in double taxation, which the agreement intends avoiding. Decisions of the foreign courts though may not be binding on the domestic courts may have persuasive influence on them. These courts should persuade themselves in accepting them, and should interpret the agreement in the same way - *Corocraft Ltd. v. Pan American Airways Inc.* [1968] 3 WLR 1273.

Double taxation agreement - Structure

2.8 Each double taxation agreement is a composite compromise between domestic tax laws of the contracting States. That compromise takes a standard form *i.e.*, either the OECD or the UN Model. It is concerned with the substantive law of the States. It does not deal with procedural part how the obligation thereunder performed. It is divided into seven chapters. The treaties follow this pattern. The following is the scope of the respective chapters :

1. Scope of the Convention, which regulates the requirements for the application of the treaty (Chapter I; articles 1 and 2);
2. Determination of the essential definitions of treaty terms (Chapter II; articles 3, 4 and 5)
3. Distributive rules regarding income taxes (Chapter III; articles 6 to 21); the respective rights to tax of the state of source or situs and of the state of residence;
4. Distributive rules regarding taxation of capital (Chapter IV; article 22);
5. Methods for the elimination of double taxation (Chapter V; articles 23A and 23B); the state of residence has the obligation to eliminate double taxation by exemption or credit method;
6. Special provisions regarding discrimination, mutual agreement procedure for resolving uncertainties, exchange of information, reservation of privileges of diplomats and consular officials, and rule for extending the treaty to dependent territories (Chapter VI; articles 24 to 28);

7. Final provisions regulating the entry into force and the termination of the treaty (Chapter VII; articles 29 and 30).

In some cases there is a protocol or other documents attached to the treaties. Such documents elaborate and complete the text of a treaty, sometimes even altering the text. They are part of the treaty.

Double taxation agreement - Distributive rules regarding income-tax

2.9 The distributive rules determine how much revenue each State will receive from income arising from a particular transaction or activity. That determination is made by the use of such expressions "shall be taxed only in..." or "may be taxed in the State of source". The former means that the other State must exempt the tax; the latter, that the residence State should provide relief in the manner as provided in article 23.

In *CIT v. R.M. Muthaiah* [1993] [202 ITR 508](#), the Karnataka High Court was concerned with the double taxation agreement between Government of India and the Government of Malaysia. The High Court held that under the term of agreement, if there was recognition of the power of taxation with the Malaysian Government, by implication it takes away the corresponding power of the Indian Government. The agreement was thus to operate as bar on the power of the Indian Government to tax and that the bar would operate on sections 4 and 5 of the Indian Income-tax Act, 1961, and take away the power of the Indian Government to levy tax on the income in respect of certain categories as referred to in certain articles of the agreement. The Supreme Court in *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#), held :—

"Where liability to tax arises under the local enactment the provisions of sections 4 and 5 of the Act provide for taxation of global income of an assessee chargeable to tax thereunder. It is subject to the provisions of an agreement entered into between the Central Government and the Government of a foreign country for avoidance of double taxation as envisaged under section 90 to the contrary, if any, and such agreement will act as an exception to or modification of sections 4 and 5 of the Income-tax Act."

The distributive rule also classifies income into various types. The classification is not to be linked with the classification under the domestic laws, though there might be some similarity. The purpose of both is different. Under the treaties, it is to distribute the tax. Under the domestic laws, it is to compute the income. For the purpose of treaties, income is broadly classified into the following :—

1. Income from certain activities - business, independent and dependent personal services, agriculture and forestry ;
2. Income from investments - dividends, interest, royalties, and income derived from immovable property;
3. Capital gains;
4. Residuary income, not covered any of the above categories.

For distribution of income and tax between contracting States, different rules apply according to the category. There are however, exceptions. There are sometimes difficulties in determining the category. Both are dealt with in the treaties. The rules governing shipping is a special exception to the business profit rule. Similarly, the rules governing the entertainers and athletes is a special exemption to the rules on independent and dependent services. If activity or investment could both be taken as source, the distributive rule governing income from investment takes priority. For example, dividend income derived from shares which are the business assets of an enterprise is treated under article 10 relating to dividends, and not under article 7 relating to business profits. Interest income is treated similarly. This is also the position under the Indian domestic law. There is, however, an exception. Taxation of dividends, interest or royalties is determined under article 7, if they are received through, and arise from the asset of, permanent establishment in the other contracting State.

Double taxation agreement - Scope

2.10 Every country may need a treaty with every other country to encourage flow of investment and trade. Exceptions are the countries of the Middle East and the erstwhile communist bloc countries and those which have decided to become tax haven countries. These countries do not have the tax system similar to the one prevailing in European, capitalistic and other democratic countries. There is no tax levy as such in conventional sense which needs to be avoided or mitigated. They have no tax to give up as *quid pro quo* in the negotiating process. Some jurisdiction, as for example, Hong Kong, do not tax foreign sourced income, and thus, do not feel the need for a tax treaty. Thus, the scope of the agreements varies from country to country, its economic policies, advancement in

development technology, and its economic and trade relations with other contracting country. In some cases the agreement cannot be termed *stricto sensu* tax treaties because there is no tax levy as such in those countries which needs to be avoided. The treaties are more in the nature of agreements to develop maritime and air traffic relations to the best advantage of both countries. Such conventions may more appropriately be described as tax agreements rather than tax treaties. Tax treaties indicate comprehensive tax treaties, covering all sources of income arising from the flow technology or capital or transfer of services, or exchange of teachers, research workers, students and artistes. Since the economic interests of the developed and the developing countries are at variance, the former countries attempt to secure maximum tax benefits by claiming the taxability of income on the residential status of the supplier of technology or provider of capital or services ; and the later countries, by laying claim on its taxability on the basis where the income has arisen, *i.e.*, the source country. The OECD model conforms to the approach of the developed countries and the UN model, of the developing countries.

Double taxation agreement - Comprehensive and limited

2.11 Comprehensive double taxation agreements relate to taxes on income, capital gains and capital, while some others, as with the erstwhile communist countries, are limited referring only to shipping and air transport, or to estates, inheritance and gifts.

Comprehensive agreements ensure that the taxpayers in both the countries would be treated equally and on equitable basis, in respect of the problems relating to double taxation. They secure to a resident of one Contracting State relief from the other Contracting State in addition to what other State provides unilaterally to all non-residents regardless of whether its own residents have similar benefit in any other State, in exchange of similar benefit the former provides to the residents of another. They tailor double taxation relief to particular tax systems of the two Contracting States having different tax systems, which would have been impossible with the unilateral double taxation relief. They resolve conflict on double taxation matters by arrangement between tax authorities of the Contracting States. Finally, they make administration of tax provisions easier by agreeing to exchange of information.

Double taxation agreement and policy of Government of India

2.12 The policy adopted by the Indian Government in regard to double taxation treaties may be summed up as follows :

- Trading with India should be relieved of Indian taxes considerably so as to promote its economic and industrial development.
- There should be coordination of Indian taxation with foreign tax legislation for Indian as well as foreign companies trading with India.
- The agreements are intended to permit the Indian authorities to co-operate with the foreign tax administration.
- Tax treaties are good compromise between taxation at source and taxation in the country of residence. The main feature of the Indian tax avoidance agreements is that those which were concluded prior to 1976 provide for limited right of taxation in respect to investment income in the country of source. In the case of those which have been concluded recently, the source rule applies in respect of income by way of interest, royalty and technical service fee.
- Tax revenues are sacrificed in exchange for the economic and industrial development of the country, so as to permit flow of technology in India. In an effort to achieve the highest possible incentive effect, the Indian Government is prepared to grant full exemption of certain items of income and capital. This it does through the double taxation agreement and unilateral taxation measures. Temporary loss of revenue is tolerated in view of the long-term economic planning consideration.

In concept, the Indian tax agreements follow the OECD/UN Model. Depending upon whether the agreement is with the developed, or developing, or underdeveloped country, modification may become necessary. For example, conventions with industrialised States assume the existence of a permanent establishment when a construction site has been in existence for 6 months rather than 12 months as is specified in OECD Model.

India has one of the largest network of tax treaties for avoidance of double taxation and prevention of tax avoidance. It has tax treaties which are comprehensive, dealing with the rules for computation and allocation

between it and the other Contracting State income arising from certain activities such as business, independent personal services, dependent personal services, from assets such as dividends, interest, royalties, rents, income earned as capital gains, from sources not expressly mentioned and from business of shipping and air transport, besides covering matters of mutual interests such as exchange of teachers, research workers, students and artistes; exempting diplomatic personnel of each other's country from tax liability; dealing with exchange of information for preventing tax frauds and evasion, mutual assistance procedures, etc.

India has limited agreements with some countries, confined to profits earned from the business of shipping and/or air transport.

Conventions entered into by India with various foreign countries have several common features. The pattern in drafting of the avoidance provision is clearly discernible. The agreements between 1959 and 1976 follow almost the same pattern. Thereafter, there have been many changes. The year 1976 is the year of changes in the Indian Income-tax Act (hereinafter referred to as 'the Act') affecting the non-residents. For taxability of income, by way of royalties and fees for technical services the emphasis is on income having arisen in India. Deduction of head office expenses can be allowed. For computing income by way of royalty or fee for technical services or interest, section 44D of the Act provides that no deduction in respect of any expenditure would be allowed after 1-4-1976. The main feature of Indian tax avoidance agreement prior to 1976 is provision for limited right of taxation in respect of investment income in the country of the source. In the case of those which have been concluded recently, the source rule or the doctrine of force of attraction in respect of income by way of interest, royalty and technical service fee, has been given prominence. Thus, there is specific departure from the OECD Model. The approach of this model is broadly to reserve the right to tax income and gains to the country where the taxpayer is resident. The UN Model which was published in 1980 is, therefore, followed generally by India. It gives greater taxing rights to the country where the income or gains arise. This is done, for example, by providing for high maximum rate of withholding taxes on dividends, interest, royalties and similar items and by allowing countries to retain most of the taxing powers available under the domestic laws for foreign business operating in their territories.

Double taxation agreement and taxation in India of non-residents

2.12A Under the Indian tax laws income which is subject to charge to tax is, *inter alia*, income which accrues or arises or deemed to accrue or arise in India or which accrues or arises outside India, if the assessee is resident in India. In case of a non-resident assessee, income which accrues or arises outside India is not taxable. The chargeability of income depends—

- a. upon the residential status of the assessee who is treated resident of the both countries according to their laws, in respect of that income, or
- b. upon the concept of income as meaning to accrue or arise anywhere in the world.

Dependence of the taxability of income upon (i) the residential status of the assessee, and (ii) the location of the source of income results often time in double taxation. So that the same income may not suffer tax twice, once in the country of its source and again in the country of residence of an assessee, some relief has to be provided or measures have to be taken to avoid occurrence of such a situation. Three important factors which determine the liability of a non-resident are (1) residence; (2) source of income; and (3) permanent establishment.

Treaty access

2.13 In order to get the benefit of a tax treaty, it is necessary to have an access to it. For that purpose, a person must qualify in terms of the treaty as a :

- person,
- resident of any of the Contracting States; and
- beneficial owner of the income by way of dividends, interest or royalties for a lower rate of withholding tax.

These concepts have great relevance in the case of investment funds, as it has to be determined whether a fund could be regarded a person, a resident and the beneficial owner of the foreign income it receives by way of dividends, interest or royalties. These are discussed in the relevant chapters.

Double taxation agreement - Residence of a person

2.13-1 The determination of the residential status assumes significance, as the taxability of income under the domestic laws, depends upon it, and as also only the resident of a Contracting State can seek relief from double taxation. For tax purposes, the domiciliary status of a person has a practical meaning in the sense of a residence, the physical presence in a country, enabling it to apply its tax laws. Since residence is a factual concept, the criterion for its determination may differ substantially.

The possibility of a person of having dual residential status cannot be ruled out because he may qualify for that status in relation to one State according to some criterion and may also qualify for similar status in relation to the other according to some other criterion. Such a situation may result in taxation of income in more than one country. The difficulty is resolved by laying down circumstances when he could be considered resident either of this or of that State.

Tax agreements, therefore, contain a provision to avoid dual residence by listing a number of precise criteria. The exclusion of dual residence is for pragmatic reasons. Such a provision is valid for the purpose of relationship between both the contracting states as regulated by the agreement. Beyond the aims and object of the agreement, the residential status as determinable under the domestic laws remains unchanged. The determination of fiscal domicile for the purpose of the concerned agreement has been discussed in detail later.

Double taxation agreement - Source of income of a person

2.13-2 Source means not a legal concept but something which a practical man should regard as a real source of income - *CIT v. Lady Kanchanbai* [1970] [77 ITR 123](#) (SC). A person may have separate sources of income. All taxable income must necessarily have a definite source - *Sterling Foods v. CIT* [1984] [150 ITR 292](#) (Kar.). The word 'source' therefore, means something from which income arises - *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP). It relates not to the physical source of a flow of money or the physical situs of payment but rather to the property, activity or service which produces the income. The concept of the 'source of income' was first introduced in the United States tax system in 1916 and subsequently embodied in the 1939 US tax code. It has been the rule in the United States since the inception of the concept of source of income to consider the place where service is done decisive. For instance, if services done in the US, the income from the service should be from the sources within the United States. Compensation for labour for personal services performed in a country constitutes that country's source of income. This principle applies not only to services rendered by individual or natural person but also to services rendered by or through the medium of a juridical person.

There may be circumstances that the source of income is determined to be in more than one country. Each country determines source according to its laws. The laws of two countries may come into conflict in determining it. Where a double tax agreement exists between the two countries, the problems of dual source are largely resolved, as the agreement determines the country of the source in respect of various classes of income. Where, however, no agreement applies, the recipient may be taxed in both countries in respect of the same income.

Under the double taxation agreement, the difficulty is resolved thus; taxes are levied (i) in respect of a particular source of income, by the country in which the source is located; and (ii) in respect of a person's total income, by the country where he resides, with deduction of taxes collected by other State under (i) above.

Thus, as a general principle, income with an Indian source is taxable in India. But where the person is resident of another country and he is in receipt of income in respect of an Indian source, the taxability of income in India will be determined on whether the person is non-resident in India, or whether he is a resident of a country with which India has a double taxation agreement. In case he is non-resident in India but is resident of a country with which India has no double taxation agreement, the Indian source income will be taxed in India at the normal rate. In case he is a resident of a country with which India has a double taxation agreement, the taxability of income, its extent and rate would be governed by that agreement.

Double taxation agreement - Permanent establishment of a foreign enterprise

2.13-3 Foreign company or establishment carrying on business in a wide range of circumstances is subjected to tax under the domestic laws of many countries. Even a casual activity which may not be an effective or immediate source of income is not spared. Double taxation agreement restricts the jurisdiction of the Contracting States to taxing business income only if the foreign company or establishment carries on business through a permanent establishment. Therefore, the expression 'permanent establishment' is defined extensively in all tax agreements so

as to limit the circumstances in which a company or enterprise resident in one country is taxable on business profits in the other. The effect of this provision is that variety of business operations are no longer subject to double taxation.

The expression has been defined with reference to the place and person. With respect to place it is restrictive, clarificatory and expanding. The definition consists of three parts. The one is introduced by the expression "means"; the other, by the expression "includes"; and the third by the expression "encompasses". There are also exceptions. The basic rule is that the Permanent establishment (PE) is a fixed place of business through which business of an enterprise is carried on. There is a construction PE *i.e.*, the building site, a construction, assembly or installation project. There is a service PE, *i.e.* when an enterprise renders services through its employees. There is agency PE, *i.e.*, a person acting as an agent for foreign enterprise. The test for determination whether a business presence is PE within the said definition are :

- Objective test, *i.e.*, presence of substantial physical object ;
- Subjective test, *i.e.*, right to use with somewhat permanence ;
- Functional test, *i.e.*, business activity or connection.

Normally a branch office, factory, workshop, mine, a construction site, for six months or more, or a primary production property generally constitutes a PE. An agent (other than a broker or other independent agent) who regularly concludes sales contracts for non-resident principal or regularly fills orders from India-held stocks also generally constitutes PE. However, maintaining a show room or purchase office is not of itself conclusive in determining a PE.

Double taxation agreement - Bilateral tax relief

2.14 Income that arises or accrues in one country and then flows to another, say, business profits, dividends, interest, royalties, and so on, is generally taxed by both countries according to their respective laws. If the taxation of such income is not co-ordinated a heavier burden may be imposed on that income than on domestic income. The consequences would be adverse on the international trade and economic relations.

For such co-ordination, double taxation agreements provide :

- certainty over the level of the final liability in some cases, and complete relief from tax in others;
- reduced withholding tax rates;
- dispute resolution procedure.

As regards the first above, two approaches have been used in achieving such co-ordination—one unilateral and the other bilateral. While the expression ‘bilateral’ suggests an agreement between the two countries allocating the right to tax the different categories of income and, sometimes capital, the expression ‘unilateral’ suggests case where the residence country employs measures on a unilateral basis which mitigate or prevent income that has its source in another country for being taxed twice.

Under a unilateral system of double taxation relief, the relief has to be given to every person resident of every country, irrespective of whether that country grants a corresponding relief. Under double taxation agreement, additional reliefs are provided on reciprocal or mutual basis. A relief is given in exchange of a similar relief to its resident in the other country. Taxpayers in both the countries are treated equally, when the problems relating to double taxation arise.

There is a possibility of the co-ordination of two differing tax systems, which possibly does not exist under the unilateral tax relief system. The relief could be tailored to the particular tax system of the two countries. In case there is a conflict in regard to matters on double taxation, provision for resolving them exists in the double taxation agreement. Close co-operation between the tax authorities of the two countries in regard to exchange information or working together in administration to their tax laws is promised in the double taxation agreement.

Double taxation relief - Unilateral relief

2.14-1 To mitigate hardship on account of foreign source income having to suffer tax twice, once in the country of the source and again in that of the assessee's residence, the domestic tax laws contain many measures in the form of either exempting totally or partially foreign source income, or permitting the taxpayers to deduct foreign income-tax in the same manner as other items of cost or expenses. The other measure relates to the grant of foreign

tax credit. All these measures are taken unilaterally without reference to a corresponding or reciprocal arrangement with the other country.

Relief is given under the provisions of a country's own domestic tax laws in any of the following ways :

- ❑ By exempting foreign source income and gains from domestic taxes.
- ❑ By exempting income of non-resident earned in the host country.
- ❑ By means of a credit of foreign taxes against domestic taxes on foreign source income and gains.
- ❑ By allowing foreign taxes as a deduction in computing income and gains for domestic tax purpose.

Double taxation relief - Exemption of foreign source income Double taxation relief - Exemption of foreign source income

2.14-2 One method of unilateral relief is to exempt the foreign source income. Its essential feature is that the investor's home country grants an exclusive right to the source country to tax it. It is limited to certain types of income such as business profits, inter-company dividends received by domestic companies or other persons, income from real estates, situated abroad. Tax liability is no more or no less than what it could be according to the domestic law of the source country.

Thus, there is tax neutrality. First, in the sense that the home country investor is treated at par with the nationals of the source country and thus he receives the same treatment as the domestic law extends to its nationals. Secondly, in the sense that his incomes from the home country investments and foreign source country investments are not taxed alike. Thirdly, in the sense that repatriation or non-repatriation of the profits has no influence on the amount of taxation.

As for India, exemption of foreign source income from the domestic laws is provided unilaterally in respect of some cases. Complete exemption is provided in respect of interest payable on the money borrowed from, or the debts owed to, the sources outside India by the Government or a local authority or by an industrial undertaking or the Industrial Finance Corporation or any other financial institution or a company, etc., [section 10(15)(iv) of the Act].

Double taxation relief - Exemption in respect of income of non-resident in India Double taxation relief - Exemption in respect of income of non-resident in India

2.14-3 Income earned or received in India under certain circumstances is exempted entirely or partially. Remuneration of a non-resident foreign citizen is exempt, if it is received by a technician as salary for carrying scientific research [section 10(5B) has now been omitted w.e.f. 1-4-2003] or is received as a diplomat [section 10(6) of the Act] or as an employee of a foreign enterprise provided his stay in India does not exceed ninety days [section 10(6)(vi) of the Act], or as an employee of a foreign Government deputed in India for training in Government establishment or public sector undertaking [section 10(6)(xi) of the Act], or is received in India in connection with any sponsored co-operative technical assistance programme with foreign Government [section 10(8) of the Act]. Tax paid by Government or an Indian concern in respect of income of a foreign company deriving income by way of royalty or fees for technical services received from the Government or such concern [section 10(6A) of the Act], or the tax paid on behalf of a non-resident or a foreign company in respect of its income (other than salary, royalty or technical fees) [section 10(6B) of the Act], is not taken income.

Double taxation relief - Foreign tax credit system Double taxation relief - Foreign tax credit system

2.14-4 Under the foreign tax credit system, foreign income of residents is subject to Indian income-tax. However, upto the amount not exceeding the Indian income-tax payable thereon, the foreign tax paid will be credited against the total tax liability in India arising from the receipt of foreign income. Thus, an Indian resident pays tax on foreign income as if it were received or it had accrued in India. The effect of such credit is to impose 'tax neutrality' prompting a decision on the part of an Indian resident in regard to location of the source of income to a country where the tax rate is low. In treating foreign and domestic taxes alike, the countries observe strict neutrality as regards foreign and domestic investment. Such treatment neither encourages nor discriminates against the foreign investment.

The common feature of a foreign tax credit system is that the creditable foreign taxes cannot exceed the source or 'residence' country's tax on the foreign income. Failing such a foreign tax credit limit, the excess credit arising could be offset against tax on domestic income, reducing the home country's revenue collections. In setting a

foreign tax credit limit, two options are available, namely, a country-by-country or a worldwide limit. In the case of a former the foreign tax credit limit is calculated separately for each country and excess credits from high tax countries cannot be used to offset low taxes in other countries. In the case of latter, an averaging of high and low taxes is taken, providing enough scope to the taxpayer for planning taxes with a view to reducing their incidence to the minimum.

There is another mode of following the foreign tax credit system. The countries which follow this system allow a 'deemed paid' foreign tax credit for profits taxes paid by foreign subsidiaries of domestic corporations, to the extent that such profits are distributable in the form of dividends. Such a practice is like a scheme popularly known as 'imputation system'. An imputation system of company taxation imputes to shareholders tax that has already been paid by their company or corporate profits. The 'imputation system' is of recent origin and tends to eliminate the double taxation of the company profits which the classical system imposes. A shareholder receives a tax rebate for the tax paid on the company's income. Tax payments are passed on to the shareholders in the form of franked dividends, with the amount of dividend carrying a full tax rebate having termed the franked amount of dividend.

But the foreign tax credit system and imputation system of company tax have important interaction. The most significant relationship is that the foreign tax credits to which a domestic company is entitled to cannot be passed on to the shareholders. The imputation system is effective or operative up to one stage alone and cannot be extended to a second degree of recipients. The domestic company is the beneficiary of the imputation system in respect of the income received by it as dividend from its foreign subsidiary.

Its shareholders cannot be entitled to have the benefit of credit for the foreign tax paid by the foreign company. They only receive a tax rebate for the actual domestic tax paid computed after making allowance of the foreign tax credit received by that company. However, if an individual has been shareholder in the foreign company, and not *via* the domestic company, he would have received the foreign tax credit. To that extent discrimination exists in his favour *vis-a-vis* an individual who is recipient of a profit of the foreign company *via* the domestic company.

Thus, the essential feature of foreign tax credit is that the country allowing deduction for it treats it as if it were paid to itself, within certain statutory limitations of its domestic laws. Its main defect, however, is that any tax benefit given by the source country in order to attract foreign investment either on account of low rate of tax or of special tax concessions, accrues to the country of investor rather than to himself for whom the benefit is designed. The revenue is shifted from the source to the residence country. This defect is somewhat mended through the doctrine of 'tax sparing' discussed in detail elsewhere in the book.

Further, unilateral measures to eliminate excessive tax burden are insufficient and inadequate. Satisfactory accommodation of the conflicting tax claims could be agreed upon bilaterally, which otherwise could not have been possible. The provisions under the domestic laws for unilateral tax relief are inflexible. Conflicting tax claims cannot be reconciled under them. Bilateral tax treaty permits a degree of mutual adjustment and accommodation.

Unilateral relief and section 91 of the IT Act

2.15 Indian Income-tax Act seeks to reduce the impact of double taxation by allowing foreign taxes to be credited against the amount of tax as is chargeable in India on the same income [section 91]. This is done unilaterally. The credit allowable is worked out as follows, but it will never exceed the amount of Indian income-tax which becomes due and payable :

- ❑ Where the foreign tax equals to the Indian tax rate, only the foreign tax will be payable.
- ❑ Where the foreign tax exceeds the Indian tax, no tax will be payable in India.
- ❑ Where the foreign tax paid is less than the Indian tax, there is a liability on the balance up to the Indian tax rate.

The benefit of such adjustment is given only in case the person is resident in India during the relevant year.

In order that an assessee is entitled to claim deduction on the double taxed income, the following requirements have to be satisfied :

- ❑ The assessee must have been resident in India in the relevant previous year.
- ❑ Income must have accrued or arisen to him during that previous year outside India.
- ❑ In respect of that income which has accrued or arisen outside India, he must have paid by way of deduction or otherwise tax under the law in force in the country in question.

If the above conditions are satisfied, the assessee is entitled to deduction from the income-tax payable by him in India of a sum calculated on such doubly taxed income at the Indian rate of tax or at rate of tax of the said country, whichever is lower.

‘Such doubly taxed income’, meaning of ‘Such doubly taxed income’, meaning of

2.15-1 The entitlement of an assessee to deduction extends to ‘such doubly taxed income’. Therefore, this expression requires detailed discussion. The expression ‘such’ must not only refer to the category of income included in the gross total income but also to the quantum of income so included - *see Distributors (Baroda) (P.) Ltd. v. Union of India* [1985] [155 ITR 120](#) (SC). The category of income included in the total income should be that which has already suffered tax in the foreign country. Thus, the expression ‘such’ refers to the income which accrues or arises outside India during the previous year, and the expression ‘doubly taxed income’, in its plain grammatical meaning refers to foreign income-tax under the Indian law - *CIT v. C.S. Murthy* [1988] [169 ITR 686](#) (AP). The words ‘such doubly taxed income’ can have reference to the tax which the foreign income bears once again the burden of Indian income-tax by its being included in the total income chargeable under section 4 - *K.V.AL. M. Ramanathan Chettiar v. CIT* [1973] [88 ITR 169](#) (SC).

The main requirement, therefore, is that the income must have been taxed outside India and the same income must have been taxed under the Income-tax Act in India. If any portion of the foreign income is not subjected to tax in India, then the assessee would not be entitled to claim deduction on that part of the income which is not so subjected to tax. Merely including the foreign income in the total income, it cannot be said that the foreign income is subjected to tax. The criteria are not only that the foreign income be included in the total income in the assessment made under the Income-tax Act in India, but that it should also be subjected to tax in this country. The real test, therefore, is whether the income in respect of which tax deduction is claimed by the assessee is subjected to tax under the Income-tax Act. If any slice of foreign income is not subjected to tax in the assessment made in India, it is not possible to treat such foreign income as subjected to tax in India and also as forming part of doubly taxed income for the purpose of section 91.

In *CIT v. C.S. Murthy* [1988] [169 ITR 686](#) (AP), a question arose before the Andhra Pradesh High Court, whether the assessee was entitled to relief, under section 91 of the Act of the entire tax deducted at source by the foreign Government, or only of that amount which is referable to the income subjected to tax in India. The facts of this case were :

The assessee, who was employed as a dental surgeon in India, went on deputation to Iran. He received a salary of Rs. 64,470 from the Government of Iran, wherefrom tax of Rs. 5,974 was deducted. This amount was also to be included in the total income of the assessee in India by virtue of section 5(1)(c) of the Act. The assessee was entitled to deduction of 50 per cent of such income under section 80RRA. The Income-tax Officer allowed deduction of Rs. 32,235. In respect of the double taxed income, he held that although the assessee received the remuneration of Rs. 64,470 from the foreign employer, the amount that was doubly taxed under the Act was only one-half as the balance half was allowed as deduction under section 80RRA and hence the assessee was entitled to relief under section 91 only on Rs. 32,235. The tax at the rate applicable in Iran on the sum of Rs. 32,235 was ascertained at Rs. 2,986 and as that tax was less than the Indian rate of tax, the said amount of Rs. 2,986 was allowed deduction from out of the tax payable by the assessee. The High Court, while upholding the view taken by the Income-tax Officer, held that the relief by way of deduction of tax under section 91 should be confined to the amount doubly taxed in accordance with the provisions of the Act and not to the full amount received by the assessee from the foreign employer.

D.P. MITTAL’S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT AND DOMESTIC LAW

IntroductionIntroduction

3.1 Making a treaty involves negotiation, signing, ratification and incorporation into the domestic laws of the Contracting States. A treaty is an international agreement concluded between States in written form and governed by International law. Making a treaty is an executive act, while performance of its obligations, if they entail alteration of the existing domestic law, requires legislative action. The stipulations of a treaty duly ratified, by virtue of the treaty alone, do not have the force of law - *see Attorney-General for Canada v. Attorney General for Ontario* [1937] AC 326. Adoption of a double taxation agreement requires modification to the internal tax laws of the State. In some States, legislation is needed, while in others, it is considered part of the Constitutional law, being a treaty or agreement concluded under international law. This is so done because taxpayers may be subject to the agreement and get benefit arising from its provisions. The said agreement is the interaction between its substantive rules and the national procedure rules. The Constitution of India does not render the treaties to which India is a party the law of the land. Obligations arising therefrom, therefore, are not judicially enforceable, unless backed by legislation - *State of West Bengal v. Jugal Kishore* AIR 1969 SC 1171. No legislation is needed if its implementation is possible at the administrative level and without legislative endorsement - *see State of Gujarat v. Vora Fiddali* AIR 1964 SC 1043. Treaties are not self operating - *Salomon v. Commissioners of Custom and Excise* [1967] 2 QB 116. It means that a treaty is not a part of the law unless and until it has been incorporated into the law by legislation - *Pan-American World Airways Inc. v. Department of Trade* [1976] 1 Lloyd's Rep. 257. Its enforcement and effectiveness within India could not be possible till then. A treaty does not apply internally. It requires an enabling Act of the Parliament. Section 90 of the Indian Income-tax Act, 1961, is such an Act. It empowers the Central Government to enter into an agreement with any country for granting relief from and avoidance of double taxation, exchange of information, recovery of tax and to make such provisions as may be necessary for implementing the agreement, by a notification in the Official Gazette. That section empowers the Central Government to enter into an agreement on behalf of the State. It also serves another purpose. The concluded agreement is incorporated in the Income-tax Act. Its enforceability and applicability have the legislative backing. Double taxation agreements have the status of treaty. In case of conflict between the domestic law and the provisions of the treaty, the latter prevail.

International agreement - An attribute of sovereigntyInternational agreement - An attribute of sovereignty

3.2 The right of entering into international engagements is an attribute of sovereignty. International law, however, leaves it to the national law the determination of the State organ which is competent to conclude a treaty on behalf of its State. Article 73 of the Constitution of India extends the executive power to the matters enumerated in List-1, including the matters in entry 14 thereof on entering into treaties and implementation of treaties and to exercise of such rights, authority and jurisdiction as are exercisable by the Government of India by virtue of any treaty agreement. Accordingly, the Central Government is competent to represent the State and may by treaties incur obligations and to give effect to treaties - *Maganbhai v. Union of India* AIR 1969 SC 783. As aforesaid, the Central Government has been empowered to enter into tax treaty and to make provisions of its implementation (*see* section 90 of the Income-tax Act, 1961).

The Supreme Court in *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#)/[2003] [132 Taxman 373](#) (SC) observed:

"The power of entering into a treaty is an inherent part of the sovereign power of the State. By article 73, subject to the provision of the Constitution, the executive power of the Union extends to the matters with respect to which the Parliament has the power to make laws. Our Constitution makes no provision making legislation a condition for the entry into an international treaty in time either of war or peace. The executive power of the Union is vested in the President and is exercisable in accordance with the Constitution. The Executive is *qua* the State competent to represent the State in all matters international and may by agreement, convention or treaty incur obligations which in international law are binding upon the State. But the obligations arising under the agreement or treaties are not by their own force binding upon Indian nationals. The power to legislate in respect to treaties lies with the Parliament under entries 10 and 14 of List I of the Seventh Schedule. But making of a law under that authority is necessary when the treaty or agreement operates to restrict the rights of the citizens or others or modifies the law of the State. If the rights of the citizens or others which are justiciable are not affected, no legislative measure is needed to give effect to the agreement or treaty (*see* in this connection *Maganbhai Ishwarbhai Patel v. Union of India* [1970] 3 SCC 400)" (page 721 of ITR).

Double Taxation Agreement - Incorporated as part of the Indian Income-tax Act

3.3 The parties to the treaty are the States, not their subjects. If it affects their private rights, it must be incorporated into the domestic laws. The manner of doing it varies from State to State. Its signing does not signify State's consent to be bound by it, unless specifically provided in the treaty that a signature constitutes entry into force. It only signifies that the State would proceed with the ratification of the treaty. Thus, there is a distinction between the signing, the ratification, and the incorporation of the treaty in the domestic laws. Ratification of the treaty signifies the State's consent to be bound by it. The private rights are not affected unless the treaty itself is given force of law.

When it come to fiscal treaties dealing with double taxation avoidance, different countries have varying procedures. In the United States such an agreement becomes a part of the municipal law upon ratification by the Senate. In the United Kingdom, it would have to be endorsed by an order made by the Queen in Council. Since in India such an agreement would have to be translated into an Act of Parliament, a procedure which would be time consuming and cumbersome, a special procedure was evolved by enacting section 90 of the Indian Income-tax Act, 1961.

The Central Government is empowered not only to enter into an agreement with other Country, but also make such provisions, by notification in the Official Gazette, as may be necessary for implementing it. (Section 90 of this Income-tax Act, 1961)

Thus, once an agreement is notified in the Official Gazette, it is incorporated in the Income-tax Act. On such notification, it is the law. It is a part of the scheme under the Income-tax Act [see *Ishikawajima-Harima Heavy Industries Ltd. v. DIT* [2007] [158 Taxman 259](#) (SC)].

Section 4 of the Income-tax Act, creates a charge on the total income of a person "subject to the provisions of this Act." Section 5 defines the scope of "total income" which is also "subject to the provisions of this Act". Thus, the charge on, and the scope of, the total income are subject to the provisions including section 90 of the Income-tax Act. By necessary implication they are subject to the terms of double taxation agreement - *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP). The double taxation agreement and the Income-tax Act form a single statute. The expression "subject to" conveys the idea of a provision yielding place to another provision or provision to which it is made to subject. The Supreme Court in *K.R.C.S. Bala Krishna Chetty & Sons & Co. v. State of Madras* [1951] STC 114, held that the use of the word "subject to" has reference to effectuating the intention of the law and the correct meaning is "conditional upon". Thus, the total income of a person is subject to the provisions of the double taxation agreement. This means supremacy of the double taxation agreement.

It contains legal basis to make implementing regulations. The basis for their enforcement is formed by the procedure laid down in domestic laws. Legal remedies available thereunder are made use of. If the agreement contains special provision for implementing, it must be implemented accordingly.

The Authority for Advance Ruling observed as follows in P. No. 13 of 1995 [1997] [94 Taxman 171](#) (AAR- New Delhi) (headnotes) :—

"It is well-established that where a matter is governed by the provisions of the Act and also by a DTA, the provisions of the DTA should prevail unless the statutory provision is more beneficial to the assessee. Reference may be made in this connection to section 90(2), Circular No. 333, dated 2-4- 1982 issued by the CBDT - (1982) 137 ITR (St.) 1- and the decision of the Madras High Court in *CIT v. V.R.S.R.M. Firm* [1984] [208 ITR 400](#) ."

Double taxation agreement - Power under section 90 of the Income-tax Act, some features

3.3-1 Section 90 of the Income-tax Act, 1961, empowers the Central Government to enter into an agreement with the Government of any country outside India for granting relief in respect of income which has been doubly taxed or in respect of income-tax chargeable to promote mutual economic relations, trade and investment, for avoidance of double taxation, exchange of information for prevention and evasion or avoidance of tax, for recovery of tax.

The purpose of section 90 becomes clear by reference to Legislative its history. Section 49A of the Income-tax Act, 1922 enabled the Central Government to enter into an agreement with the Government of any country outside India for the granting of relief in respect of income on which, both income-tax (including super-tax) under the Act and the income-tax in that country, under the Income-tax Act and the corresponding law in force in that country, had

been paid. The Central Government could make such provisions as necessary for implementing the agreement by notification in the Official Gazette. When the Income-tax Act, 1961, was introduced, section 90 contained therein initially was reproduction of section 49A of the 1922 Act. The Finance Act, 1972, modified section 90 and brought into force with effect from 1-4-1972. The object and scope of substitution was explained in circular of the Central Board of Direct Taxes (No. 108 dated 20-3-1973) as to empower the Central Government to enter into agreements with foreign countries, not only for the purpose of avoidance of double taxation of income (or for the purpose of promoting economic relations, trade and investment, *vide* Finance Act, 2003, w.e.f. 1-4-2004), but also for enabling the tax authorities to exchange information for the prevention of evasion or avoidance of taxes on income or for investigation of cases involving tax evasion or avoidance or for recovery of taxes in foreign countries on a reciprocal basis. In 1991, the existing section was renumbered as sub-section (1) and sub-section (2) was inserted by the Finance Act, 1991 with retrospective effect from April 1, 1972, providing that the application of the provisions of Income-tax Act, 1961 to the extent they are more beneficial to the assessee. In 1991, explanation below the section was added by the Finance Act, 2001, w.e.f. 1-4-1962, providing that charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company in the circumstances mentioned therein.

The scope, effect and the power of the Government in relation to double taxation agreements are as follows as could be culled up from the decision of the Supreme Court in *Azadi Bachao Andolan (supra)* and *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#) (SC) :

- Section 90 was brought into the statute book precisely to enable the executive to negotiate a Double Taxation Avoidance Agreement and quickly implement it.
 - It is specifically intended to enable and empower the Central Government to issue notification for implementation of the terms of a Double Taxation Avoidance Agreement.
 - The provisions of such an Agreement, with respect to cases to which they apply, would operate even if inconsistent with the provisions of the Income-tax Act.
- When the requisite notification has been issued under section 90, the provisions of sub-section (2) of section 90 springs into operation and an assessee who is covered by the provisions of the Double Taxation Avoidance Agreement is entitled to seek the benefits thereunder, even if the provisions of that Agreement are inconsistent with those of the Act.
- Even accepting that the powers exercised by the Central Government under section 90 are delegated powers of legislation, there is no reason why a delegate of legislative power, in all cases, has no power to grant exemption. The delegate of legislative power can exercise the power of exemption in a fiscal statute.
- A circular issued by the Central Board of Direct Taxes providing clarification within the meaning of section 90 must have the legal consequences contemplated by section 90(2) and, therefore, shall prevail even if inconsistent with the provisions of the Income-tax Act, 1961, insofar as assessee covered by the provisions of the Double Taxation Avoidance Agreement are concerned.
- The total income specified in sections 4 and 5 of the Income-tax Act, 1961, chargeable to income-tax is also subject to the provisions of the Double Taxation Avoidance Agreement to the contrary, if any. Such an Agreement operates as a bar on the power of the Government of India and the bar would operate on sections 4 and 5.
- No provision of the Agreement can possibly fasten a tax liability where the liability is not imposed by the Act.
- If tax liability is imposed by the Act, the Agreement may be resorted to for negating or reducing it.
- In case of difference between the provisions of the Act and the provisions of the Agreement, the provisions of the Agreement would prevail.

The effect of an agreement entered into by virtue of section 90 of the Income-tax Act would be:

- (i) if no tax liability is imposed under the Act, the question of resorting to the agreement would not arise. No provision of the agreement can possibly fasten a tax liability where the liability is not imposed by the Act ;
- (ii) if a tax liability is imposed by the Act, agreement may be resorted to for negating or reducing it;
- (iii) in case of difference between the provisions of the Act and of the agreement, the provisions of the agreement prevail over the provisions of the Act and can be enforced by the appellate authorities and the Court

[see *CIT v. R.M. Muthaiah* [1993] [202 ITR 508](#) (Kar.)]

Double taxation agreement and domestic law conflict

3.4 Unlike conflict rules in private international law, tax treaties do not choose between domestic and foreign law. States have original jurisdiction to tax. Tax treaties recognise that each State applies its own laws. They do not allocate jurisdiction to tax between the contracting States. The jurisdiction remains with each State according to its domestic law. They agree only to restrict their substantive tax law reciprocally. In case of overlapping of substantive law, the agreement decides which of them is bound to withdraw its tax claim. The tax treaties are the mechanism to avoid double taxation through the division of tax claims. They neither generate a tax claim that does not otherwise exist under the domestic law, nor expand the scope or alters the character of the existing claims. There could, therefore, be little possibility of conflict between the domestic law and the tax treaties. In case, however, of any between the provisions of the Income-tax Act and the double taxation agreement, the latter would prevail. Reasons are discussed in the following paragraphs:—

Double taxation agreement - Doctrine of generalia specialibus

3.4-1 Through the mandate of the Parliament, a treaty has the same authority as internal law. It is considered as special provision. It overrides general provisions, on the basis of the doctrine *generalia specialibus non derogant* which literally means that the general words or things do not derogate from special. This expression was explained to mean that when there is a conflict between a general and special provision, the latter shall prevail - *CIT v. Shahzada Nand & Sons* [1966] [60 ITR 392](#) (SC) and *Union of India v. Indian Fisheries (P.) Ltd.* AIR 1966 SC 35, or the general provisions must yield to the special provisions - *State of Gujarat v. Ramjibhai* AIR 1979 SC 1098. The general provision controls the cases where the special provision does not apply as the special provision is given effect to the extent of its scope - *South India Corpn. (P.) Ltd. v. Secretary Board of Revenue* AIR 1964 SC 207. Thus, a particular or a special controls or cuts the general rule - *Bengal Immunity Co. v. State of Bihar* AIR 1955 SC 661. Since the treaty provisions are the special provisions, they are not to be altered by a subsequent law unless the law expressly contradicts. Section 90 of Indian Income-tax Act, 1961 confirms this principle and grants tax treaties priority over domestic law. Tax agreements being special rules precede tax laws - *Salomon v. Commissioner of Customs & Excise* [1966] 3 WLR 1223, *Woodend Rubber Co. v. CIR* [1970] 3 WLR 10.

Double taxation agreement - Binding - Board's circular

3.4-2 The Central Board of Direct Taxes have issued a circular [Circular No. 333, dated 2-4-1982 reproduced in [1982] 137 ITR (St.) 1] that the Assessing Officers should give effect to the provisions of the double taxation avoidance agreement in case the provisions of the agreement are not in conformity with the provisions of the Income-tax Act. Circulars by the Board have to be mandatorily followed and are binding on the Assessing Officers - *Navnit Lal C. Javeri v. K.K. Sen, A.A.C.* [1965] [56 ITR 198](#) (SC), *Ellerman Lines Ltd. v. CIT* [1971] [82 ITR 913](#) (SC) and *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#). In *CIT v. Davy Ashmore India Ltd.* [1991] [190 ITR 626](#) (Cal.), while dealing with the said circular held that in case of inconsistency between the terms of agreement and the taxation statute the agreement would alone prevail; and that the circular reflected the correct legal position inasmuch as the agreement arrived at the deviation from the general principles of taxation applicable to the Contracting States. Otherwise, the DTA will have no meaning at all [see also *Leonhardt v. CIT* [2001] [249 ITR 418](#) (Cal.)].

Double taxation agreement prevails as per provision of section 90 of the Income-tax Act

3.4-3 Section 90 impliedly provides that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country, except where the provisions to the contrary have been made in the agreement. Thus, where a double taxation agreement provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions of the Act. Where there is none, it is the basic law *i.e.*, the Income-tax Act that will govern the taxation of income. Sub-section (2) to section 90 was inserted by the Finance (No. 2) Act, 1991, operative with effect from 1-4-1972, to the effect that the provisions of the Income-tax Act, apply to the extent they are more beneficial to the assessee. The provisions which are not so beneficial are not applicable. In that case provisions of tax agreement prevail. The conflict, if there is any, between the provisions of

the agreement and the Act, must be conflict between the two clear and specific provisions - *Advance Ruling Application No. P-16 of 1998, In re* [1999] [102 Taxman 377](#) (AAR-New Delhi).

The Supreme Court in the case of *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) observed as follows (p. 724) :

"A survey of the aforesaid cases makes it clear that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a double taxation avoidance agreement. When that happens, the provisions of such an agreement, with respect to cases to which where they apply, would operate even if inconsistent with the provisions of the Income-tax Act. We approve the reasoning in the decisions which we have noticed. If it was not the intention of the Legislature to make a departure from the principle of chargeability to tax under section 4 and the general principle of ascertainment of total income under section 5 of the Act, then there was no purpose in making those sections "subject to the provisions" of the Act. The very object of grafting the said two sections with the said clause is to enable the Central Government to issue a notification under section 90 towards implementation of the terms of DTAs which would automatically override the provisions of the Income-tax Act in the matter of ascertainment chargeability to income-tax and ascertainment of total income, to the extent of inconsistency with the terms of the DTAC."

The Supreme Court in *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#), held :—

"The provisions of such agreement cannot fasten a liability where the liability is not imposed by a local Act. Where a tax liability is imposed by the Act, the agreement may be resorted to either for reducing the tax liability or altogether avoiding the tax liability. In case of any conflict between the provisions of the agreement and the Act, the provisions of this agreement would prevail over the Act in view of the provisions of section 90(2)."

Double taxation agreement - Between two sovereign States Double taxation agreement - Between two sovereign States

3.4-4 The most important of all is the consideration that double taxation agreements are the treaties between the two sovereign States. They, therefore, should be implemented faithfully even if their provisions may conflict with domestic laws.

Treaty - Binding nature - Exceptions Treaty - Binding nature - Exceptions

3.5 The binding nature of the treaty is not without exceptions. A later domestic tax legislation may override tax treaty provisions whenever there is a irreconcilable conflict. Sovereign power of the Parliament extends not only to the making but also breaking a treaty. Unilateral cancellation of tax treaty through an amendment to the internal law subsequent to conclusion of the tax treaty is a recognised sovereign power. If after the agreement has come into force, an Act of Parliament is passed which contains contrary provision, the scope and effect of the legislation cannot be curtailed by reference to the agreement. The agreement is entered into pursuant to the power conferred upon the Government by section 90. A subsequent legislation cannot be controlled by the agreement.

But section 90 was amended in 1991, with retrospective effect from 1-4-1972, providing that the provisions of the Income-tax Act shall apply to the extent they are more beneficial to the assessee. Thus, the inconsistent amending provision will have no effect. Circular by the Central Board of Direct Taxes, No. 621 dated 19-12-1991 explains :

"43. *Taxation of foreign companies and other non-resident taxpayers.*—Tax treaties generally contain a provision to the effect that the laws of the two contracting States will govern the taxation of income in respective State except when express provision to the contrary is made in the treaty. It may so happen that the tax treaty with a foreign country may contain a provision giving concessional treatment to any income as compared to the position under the Indian law existing at that point of time. However the Indian law may subsequently be amended reducing the incidence of tax to a level than what has been provided in the tax treaty.

43.1 Since the tax treaties are intended to grant tax relief and not to put residents of a contracting country at a disadvantage *vis-a-vis* other taxpayers, section 90 of the Income-tax Act has been amended to clarify that any beneficial provision in the law will not be denied to a resident of a contracting country merely because the corresponding provision in the tax treaty is less beneficial."

After a treaty has been made circumstances may alter. It may be reasonable to take unilateral action in the expectation that the other party would not object,—observed by the House of Lords in *Collco Dealings Limited v. IRC* [1961] 1 All ER 762. In that case, there was a Double Taxation Relief Agreement between the United Kingdom and the Republic of Eire. By a later enactment, Finance (No. 2) Act, 1959 *vide* section 4(2), repayments of income-tax were denied to "a person entitled under any enactment to an exemption from income-tax" where certain defined circumstances existed. A company resident in Eire claimed that notwithstanding the existence of such circumstances in its own case, it was entitled to repayment because the later enactment must be regarded as leaving such entitlement unaffected. The House of Lords rejected this contention. Lord Radcliffe said :—

"It is, no doubt, true that statutory words apparently unlimited in scope may be given a restricted field of application if there is admissible ground for importing such a restriction; and the consideration that, if not construed in some limited sense, they would amount to a breach of international law is well recognised as such a ground. But a supposed intention not to depart from the observance of the comity of nations is a much vaguer criterion by which to determine the range of a statute; and when the departure consists of no more than a provision inconsistent with an inter-governmental agreement about taxation which by its own terms is subordinated to the approval of the respective Legislature of the countries concerned and persists only so long as its terms are maintained in force as law by those Legislatures. I think that there is no useful aid at all to be obtained from this principle of interpretation. The principle, depends wholly on the supposition of a particular intention in the Legislature, and I do not think that in the case before us, there is any reason to make the supposition which is suggested."

Consistent with the ruling of the House of Lords in the abovementioned case, the Supreme Court of India has also held as under, in *Gramophone Co. of India v. Birendra B. Pandey* AIR 1984 SC 667 :—

"National Courts cannot say "yes" if Parliament has said no to a principle of international law. National Courts will endorse international law but not if it conflicts with national law. National Courts being organs of the National State and not organs of International law must perforce apply national law, if international conflicts with it. But the Courts are under an obligation within legitimate limits, to so interpret the Municipal Statute as to avoid confrontation with the comity of Nations or the well-established principles of international law. But if the conflict is inevitable, the later must yield."

In *Woodend (Ceylon) Rubber and Tea Co. Ltd. v. Ceylon Commissioners of Inland Revenue* [1970] 3 WLR 10, Lord Donovan said :—

"....where there are general words in a later Act capable of reasonable and sensible application without extending them to subjects specifically dealt with by earlier legislation, you are not to hold that that earlier and special legislation indirectly repealed, altered or derogated from merely by force of such general words, without any indication of a particular intention to do so [per the Earl of Selborne LC in *Seward v. The Vera Cruz* (owners), *The Vera*]. If, however, the provisions of the later enactment are so inconsistent with or repugnant to the provisions of an earlier one that the two cannot stand together, the earlier is abrogated by the latter."

In that case the Privy Council had to consider the scope of the DTA entered into by the Government of Ceylon with the UK. It was entered into during 1950 and was given force of law by an Act called "Double Taxation (Relief) Act No. 26 of 1950". In 1959, by an Act of Parliament, an additional tax was imposed in Ceylon on non-resident companies. It was argued by the taxpayer company which was non-resident that the additional tax was contrary to the said DTA. The Privy Council came to the conclusion that section 53C of the 1959 Act was *pro tanto* in conflict with 1950 Agreement. It posed a question "What consequence follows ?" It answered by saying that the Act 1959 must prevail over the 1950 Agreement, by relying upon the well known rule of construction that if the provision of a later enactment was so inconsistent with or repugnant of the provisions of an earlier one that the two cannot stand together, the earlier is abrogated by the later.

Legislation would, thus, be required with a specific measure that is clearly irreconcilable with the treaty provision or that gives evidence of a clear intention to enforce a treaty override. Override must be specifically intended. Legislative silence is not sufficient to break the treaty (*see Trans-World Airlines v. Franklin Mint Corporation* [1984] US)

In *Salomon v. CCE* [1966] 2 All ER 340, Lord Diplock LJ laid down the following propositions :—

- ❑ Once the Government has legislated, which it may do in anticipation of the coming into effect the treaty, the court must in the first instance construe the legislation, for that is what the court has to apply;
- ❑ If the terms of the legislation are clear and unambiguous, they must be given effect to whether or not they carry out Her Majesty's treaty obligations, for the sovereign power of the Queen in Parliament extends to breaking the treaties;
- ❑ If the terms of the legislation are not clear, however, but are reasonably capable of more than one meaning the treaty itself becomes relevant, for there is a *prima facie* presumption that the Parliament does not intend to act in breach of international law, including therein specific treaty obligations ;
- ❑ If from the extrinsic evidence it is plain that the enactment was intended to fulfil Her Majesty's Government's obligations under a particular convention, it matters not that there is no express reference to the convention in the statute. One must not presume that Parliaments intend to break an international convention merely because it does not say expressly that it is intending to observe it.

As a general proposition it would appear that the legislative amendment introduced after the conclusion of a treaty could operate to restrict or revoke the tax treaty if its language is clear and unambiguous and cannot be interpreted in a way that would avoid the conflict.

In the case of *Queen v. Melford Development Inc.* 82 DTC 6281, the Canadian Supreme Court had to decide whether an amendment to the Income-tax Act also amended the Canadian-German tax treaty. The court said that in the absence of a clear indication of Parliament's intention to amend the treaty through such an amendment of the Income-tax Act the Court will not find that the treaty has been so amended.

Double taxation agreement - Limits the application of the domestic law

3.6 States levy taxes according to their domestic tax laws. Double taxation agreements recognise this principle. They, however, limit the application to certain type of income to prevent it from doubly taxed, either by excluding it or by allowing a credit of tax paid in another country. Jurisdiction to tax world wide income or wealth has been conferred upon the State by its own laws, though it is sought to be limited by the tax agreements on the basis of reciprocity. States have original jurisdiction to tax. By concluding tax agreements, they agree to restrict their substantive tax law reciprocally. In the event of occurrence of overlapping, the tax agreement decides which of the contracting States should exercise its jurisdiction to tax an income, and, which other should withdraw its claim. This, however, does not suggest that the agreements decide or allocate jurisdiction between the States. Division of tax sources, tax objects and waiver of tax claims are their purpose and intention. A State may agree to waive tax claims in favour of other State (exemption method) or to grant a credit against its tax paid in other State (credit method). The tax agreements, therefore, put limitations on the domestic tax laws in their application to income which has been subject matter of tax elsewhere. These do not invest the State with a jurisdiction to tax an income which it does not have under the domestic tax laws, or with a jurisdiction beyond what it has.

Double taxation agreement and the Indian Constitution

3.7 The reason and object of all agreements for the avoidance of double taxation or the prevention of the fiscal evasion is mainly to remove constraints on the flow of capital and technology from one country to another, so that the developing country could have access to the expertise and technical know-how of the developed country for their economic development and in the process may not unreasonably be deprived of their legitimate share in the income, as also to prevent evasion of taxes due to it on account of manipulations at international level. The executive is, therefore, empowered to grant exemption from tax or to permit taxation of certain income at a concessional rate. Such exercise of power accords with article 265 of the Constitution. This article lays down that no tax can be levied and collected except by the authority of law. Hence, the levy of tax can only be done by the authority of law and not by any executive order. Unless the executive is specifically empowered by law to give any exemption, it cannot say that it will not enforce the law as against a particular person - see *Narinder Chand Hemraj v. Lt. Governor* [1972] 1 SCR 940.

Section 90 empowers the Central Government to enter into agreement with the Government of another country to grant relief or to avoid double taxation. If in pursuance of such power exemption from tax is provided to certain categories of persons or in respect of income in its entirety or in part, such concession cannot be said to have been extended contrary to the Constitution.

Relief to a resident of another State with which India has double taxation agreement may not be available at all or available differently to the residents of another State with which no such agreement exists. It may pose a question whether the discrimination between the two persons similarly placed is not a contravention of article 14 of the Constitution, which article lays down that the State shall not deny to any person equality before the law or equal protection of law within the territory of India. The violation of this article may be on account of the State treating two assessee differently and there is no basis for such different treatment.

It is not in dispute that taxation laws must also pass the test of article 14 - *Kunnathat Thathunni Moopil Nair v. State of Kerala* AIR 1961 SC 552. But in deciding whether taxation law is discriminatory or not, it is necessary to bear in mind that the State has a wide discretion in selecting persons or objects it will tax, and the statute is not open to attack on the ground that it taxes some persons or objects and not others. It is only when within the range of its selection, the law operates unequally, and that cannot be justified on the basis of any valid classification that it would be violative of article 14 - *East India Tobacco Co. v. State of AP* [1962] 13 STC 529 (SC). A State does not have to tax everything in order to tax something. It is allowed to pick and choose persons, objects methods and even rates for taxation if it does so reasonably. Article 14 does not forbid the State from making classification of and the differentiation between persons and things, and that in order to have permissible classification the State is required to fulfil two prerequisites, namely, the classification must be found on reasonable differentiation, and secondly the differentia must have a reasonable nexus with the object sought to be achieved - *Ram Krishna Dalmia v. Justice S.R. Tendolkar* AIR 1958 SC 538 and *Rahimbhai Karimbhai Nagrewala v. B.B. Patel* [1974] [97 ITR 660](#) (Guj.).

Thus, it is not essential for the validity of tax that it must attain absolute equality and abstract justice, the reason being that it is unattainable in tax proceedings. Determination of the rate at which certain tax is to be levied is incidental to the powers of imposition of tax. Field for the exercise of the larger discretion has been admitted for this branch as well as on the same principle that absolute or perfect equality or uniformity in taxation is impossible. If the classification is rational, the Legislature is free to choose objects or taxation, impose different rates exempt classes of property from taxation, subject different classes of property to tax different ways and adopt different modes of assessment. A taxing statute is, therefore, not exposed to attack on the ground of discrimination merely because different rates of taxation are prescribed for different categories of persons, transactions, occupations or objects - *V. Venugopala Ravi Varma Rajah v. Union of India* [1969] [74 ITR 49](#) (SC).

The constitutional validity of double taxation agreement cannot be questioned on the grounds of its affording benefits to the residents of the foreign Contracting State which are not available to other non-residents.

Double taxation agreement - Application in India

3.8 As already discussed, a double taxation agreement is an instrument of international law which is binding upon the State and requires the approval of the Parliament for its domestic application. Upon such approval it is transformed into national law and is as effective as any other enacted legislation. Thus, once the agreement has been approved and put into force, it becomes the source of tax law and taken into account by the assessing authorities in the assessment process. Tax liability is imposed by the Income-tax Act and not by the double taxation agreements. If a tax liability is imposed, the agreement may be resorted to negating or reducing it, otherwise there is no question of such resorting [see *CIT v. R.M. Muthaiah* [1993] [202 ITR 508](#) (Kar.) and *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#) (SC)]. The agreement is concerned with the compromise of the substantive laws between States and not with the way in which each of the States puts the obligations of the agreement into effect. It is silent about how the states will give effect to them. This is matter of domestic law of each state. The agreements usually contain a legal basis to make implementing regulations. The basis of their enforcement is, in principle, formed by the procedure laid down in domestic laws. The beneficiaries make use of the legal remedies available under the domestic laws. The agreement conveys rights to the taxpayers covered by its provisions, which can be invoked by them in their relations with assessment authorities, through the competent authorities procedure or in court proceedings. The question is the practical application the provisions of the agreement, the objective of which, from the point of view of the taxpayer, is that the tax authority : (i) of the state of source may allow relief from payment of tax ; or (ii) of the state of residence may allow a tax exemption or tax credit.

Non-resident corporations - Procedure of assessment under the Indian Income-tax Act

3.8-1 Under the Indian Income-tax Act, 1961, jurisdiction to tax lies on the basis of the principles of residence of the person and the source of income. Indian residents are subject on their worldwide income, computed in accordance with the provisions of the Act, on net basis. Tax paid in a foreign country in respect of foreign sourced income is, however, allowed credit. Non-residents are subject to tax on the source-based income, if it arises or deems to arise in India.

Non-resident company is chargeable under the Indian Act to

- (1) corporate tax if it carries on business in India through a PE (branch or agency);
- (2) income-tax in respect of any other income arising in India (e.g., dividend, interest or royalties); and
- (3) capital gain tax in respect of capital asset situate in India.

In India, double taxation agreements are self applicable. The taxpayer or the person responsible for withholding tax in respect of income arising in India by way of dividend, interest or royalties does not depend on any prior procedure or authorisation from the Indian tax authorities so that he may take advantage of an income-tax exemption, reduction or credit provided for under any of such tax agreements. What procedure to be followed for computation of income, paragraph 3 of the circular No. 333, dated 2-4-1982 [*see CIT v. Davy Ashmore India Ltd.* [1991] [190 ITR 626](#) (Cal.)] states:

"Thus, where a double taxation avoidance agreement provides for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income-tax Act. Where there is no specific provision in the agreement, it is basic law, i.e., the Income-tax Act, that will govern the taxation of income."

As for business income and capital gains, the agreement normally does not prescribe the mode of computation. The provisions of the Income-tax Act shall, therefore, govern taxation. For taxation of dividends, interest and royalties, the agreement provides the mode of computation in regard to certain cases; the provisions of the Income-tax Act shall not govern computation of such income.

Non-resident - Procedure for computation of business income Non-resident - Procedure for computation of business income

3.8-2 For computation of business income the double taxation agreements do not provide any procedure. Article 7 provides : "(3) In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including administrative and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere, and according to domestic law of the Contracting State in which the permanent establishment is situated. . .". Thus computation of income has to be done in accordance with the provisions of the domestic law. All the provisions of the Income-tax Act are applicable including the provisions relating to depreciation, investment losses, deductible expenses, carry forward and set off of losses etc. However, derivations are made by the DTA in cases of royalties, interest etc. Such derivations are also made under the Indian Income-tax Act. (for example sections 44BB, 44BBA etc.) [*See DIT v. Morgan Stanley and Co. Ltd.* [2007] [292 ITR 416](#) (SC)] Non-resident taxpayers are required to file return and determine their tax liability and to make payment at the same time, in accordance with the provisions of the Income-tax Act. Such assessment, however, is provisional. The exact liability is not determined by the assessee but done by the tax administration. The return only indicates a proposal, to be processed, which may be accepted as such or modified in accordance with the provisions of the Act.

Non-resident corporation - Computation of certain investment income Non-resident corporation - Computation of certain investment income

3.8-3 The self-assessment principle is allowed to operate broadly where tax is required to be withheld in respect of dividend, interest and royalty. The Indian residents have the obligation to withhold tax at the time of making payment, rather than at the end of the previous year (taxation year). Section 195 of the Income-tax Act provides that any person responsible for paying to a non-resident any sum chargeable under the Act, shall, at the time of credit of such income to the account of the payee or at any time of payment thereof in cash or cheque or draft or any mode, whichever is earlier, deduct income-tax at the rates in force. For any underpayment of tax their personal obligation is implied. The Indian resident bears a personal liability for underpayment and gives an undertaking. The Reserve Bank of India does not permit remittance unless the request is accompanied by a certificate from a chartered accountant in the prescribed form and an undertaking from the Indian resident making remittance (*see* circular No. 759 dated 18-11-1997; and circular No. 767 dated 22-5- 1998). The tax withheld is the amount worked

out at the rate provided in the relevant article of the double taxation agreement. That tax is final. It is calculated on the gross amount of income. When income is known and tax thereon is also known, there remains nothing to be determined. Determination is required when income is to be computed in accordance with the provisions of the Act for the purposes of fixing the charge and for that matter the taxpayer is required to make a self assessment of his income and declare it in a return for the tax administration to make their own assessment of income and tax. Deviations from the normal procedure are made, as observed by the Supreme Court in *Morgan Stanley* (292 ITR), by the DTA in cases of royalty, interest etc. Further, as circular No. 333 (*supra*), the particular mode of computation in respect of dividends, interest or royalties having been provided in the agreement, the same are to be followed irrespective of the provisions of the Act.

Withholding tax and tax deduction at source distinction Withholding tax and tax deduction at source distinction

3.8-4 The concept of withholding tax is available when an Indian resident pays to a non-resident certain amount by way of income on investment (e.g., dividend, interest, royalty etc.). That income is subject to withholding tax at the standard rate, as provided in section 115A (also sections 115AB, 115AC, 115AD) of the Indian Income-tax Act, or at the rate as provided in the double taxation agreement. The tax operates by imposing a charge on the payer which he may pass on to the payee by means of withholding. Withholding tax is the tax withheld from the remittance made on the gross amount of income at the provided rates ; it is final, no assessment is to be made. The case of deduction of tax at source as provided under the Income-tax Act, is different. Tax deducted at source is the deduction from the income in respect of which assessment to be made later (section 190 of the Income-tax Act) in the hands of the payee. It is not final. It is to be treated as a payment of tax on behalf of the taxpayer, which is to be given credit in the assessment to be made later on determination of the final tax liability (*see* section 199). The charge is not on the payer; it is on the payee. Tax is deducted on behalf of the payee and not withheld to discharge the charge imposed on the payer.

Indian tax laws provide for various tax regimes for foreign taxpayers, depending upon the nature and source of income. Foreign taxpayers with income connected with the conduct of business or investment in India are taxed at the rates prescribed in the Finance Act, every year, or at the rate provided in the tax treaty if it happens to be lower. The amount of income in respect of which tax has to be withheld is not subject to computation in accordance with the provisions of the Act. It does not require any assessment, when income is known. No computation is required both in regard to income or the tax. Both have been fixed by the treaty. The foreign taxpayer is not required to file a return. Section 115A(5) also provides that an assessee is not required to furnish a return of income if his total income in respect of which he is assessable consisted only of dividends or interests as referred to in section 115A(a) and tax deductible at source has been deducted at source.

The procedure for computation of income and the said taxes (in accordance with relevant Finance Act) have been provided in the Indian Income-tax Act, 1961. Corporate tax is computed and chargeable by reference to tax treaty.

For granting relief authorities may require to ascertain :

- the residential status of the beneficiary (article 4 of the OECD model);
- business profits (articles 5, 7 and 9)
- dividends (article 10)
- interest (article 11)
- royalty (article 12) and so on.

The withholding obligations are imposed on Indian residents who deal with non-residents, which come into play at the time of payments rather than at the end of the previous year (taxation year). The relief provided by a double taxation agreement may be obtained without the need of having to file a return of income or other document, especially where the Indian resident is obliged to withhold amounts on account of non-resident's tax and bears a personal liability for any underpayment.

Filing of return may not be required when income derived by the non-resident is deemed not to have arisen in India *i.e.*, income payment related to business activities which are fully performed abroad; or income payments related to services which are fully performed outside India.

DOUBLE TAXATION AGREEMENT - INTERPRETATION

IntroductionIntroduction

4.1 In the previous chapter is discussed application of double taxation agreement and the Indian domestic laws. The application is not the same thing as interpretation. There is distinction between the two. Interpretation is the process of making the meaning of the agreement clear. It determines its legal character and effects. Application is the process that comes in when the meaning of the agreement is clear; it determines the consequences of the interpretation in an individual case. Any application presupposes a preceding interpretation of the agreement. Like domestic laws, international agreements require interpretation. The need arises because of the difference of opinion of the contracting States and also because of its application. The difference of opinion can be resolved by the States themselves. In case the difference still persists, the matter could be referred to International Court of Justice, if the States have submitted to its jurisdiction. As regards disagreement with regard to the application of the treaty provisions, the domestic courts do the job. But while doing so, they do not interpret strictly as they do the domestic laws. They do it liberally, because it is an international agreement, drafted by diplomats, as a compromise. It is not a legislation.

Interpretation - Principles, Domestic lawInterpretation - Principles, Domestic law

4.2 The principles of interpretation of domestic statute are variously expressed by saying that in fiscal statutes one must have regard to the letter and not the spirit of the law; that the subject cannot be taxed by inference and analogy; that in a taxing Act there is no governing principle to look at but one has simply to go to the Act itself to see whether the tax claim is that which the statute imposes; that while construing the taxing Act, it is not the function of the court to give to the words used a strained or unnatural meaning and that the subject can be taxed only if the revenue satisfies the court that the case falls strictly within the provisions of the law; that if the statute contains a lacuna or a loophole, it is not the function of the court to plug it by a strained construction to the supposed intention of the Legislature; that the court ought not to hunt out ambiguities by an unnatural construction of a taxing section - *Murailal Mahabir Prasad v. B.R. Vad* AIR 1976 SC 313. The duty of the court is to give effect to the intention of the Legislature. That intention is to be gathered from the language employed, having regard to the context in connection with which it is employed. The court must no doubt ascertain the subject-matter to which the particular tax is intended to be applied by the statute; but when once that is ascertained it is not open to the court to narrow or whittle down the operation of the Act by considerations of hardship or business convenience or the like - *Attorney-General v. Carlton Bank* [1899] 2 QB 158. The court should study the tax laws as a whole and even if it resorts a reasonable and liberal construction. Care should be taken not to defeat the intention of the Legislature.

Interpretation - "Reasons and object of a statute" is a guideInterpretation - Reasons and object of a statute is a guide

4.2-1 A statute is best understood if we know the reason for it. The reason of the statute is the safest guide to its interpretation. The words of the statute take their colour from the reason for it. How do we discover the reason for a statute? There are external or internal aids. The external aids are Statement of Objects and Reasons appended to the Bill and the reports of Committees. Occasional excursions into the debates of the Parliament are permitted. Internal aids are the preamble, the scheme and the provisions of Act. Having discovered the reason for the statute and so having set the sail to the wind, the interpreter may proceed ahead. No provision in the statute may be construed in isolation. Every provision and every word must be looked at generally before any provision or word is attempted to be construed. The setting and the pattern are important—*Utkal Contractors & Joinery (P.) Ltd. v. State of Orissa* AIR 1987 SC 1454. These must be construed as being limited to the actual objects of the Act - *Central India Spg. & Wvg. & Mfg. Co. Ltd. v. Municipal Committee* AIR 1958 SC 341. Interpretation must depend on the text and the context. If the text is the texture, context is what gives the colour. That interpretation is the best which makes the textual interpretation match the contextual. If a statute is looked at in the context of its enactment with the glasses of the statute maker provided by such context, its schemes, sections, clauses, phrases and words may take colour and appear different than when the statute is looked at without the glasses provided by the context. With these glasses we must look at the Act as a whole and discover what each section, each clause, each phrase and each word is meant and designed to say as to fit into the scheme of the entire Act. No part of the statute and no word of it can be construed in isolation. Statutes have to be construed so that every word has a place and

everything is in its place—*Reserve Bank of India v. Peerless General Finance & Investment Co. Ltd.* AIR 1987 SC 1023.

Interpretation - Intent of the Legislature is the basic rule

4.2-2 Courts in India have generally taken the view that the ascertainment of the legislative intent is the basic rule of statutory construction and that rule of construction should be preferred which advances the purpose and object of a legislation - *K.P. Varghese v. ITO* AIR 1981 SC 1922, *State Bank of Travancore v. Mohammed Khan* AIR 1981 SC 1744, *Som Prakash Rekhi v. Union of India* AIR 1981 SC 212, *Ravulu Subba Rao v. CIT* AIR 1956 SC 604, *Govind Lal Chagga Lal Patel v. Agrl. Produce Market Committee* AIR 1976 SC 263 and *Babaji Kondaji Garad v. Nasik Merchants Co-operative Bank Ltd.* AIR 1984 SC 192. Thus, the primary and foremost task of a court in interpreting a statute is to ascertain the intention of the Legislature, actual or imputed. Having ascertained the intention, the court must strive then to so interpret the statute as to promote/advance the object and purpose of the enactment. For this purpose, where necessary the court may even depart from the rule that plain words should be interpreted according to their plain meaning. There need be no meek and mute submission to the plainness of the language. To avoid patent injustice, anomaly or absurdity or to avoid invalidation of a law, the court would be well justified in departing from the so-called golden rule of construction so as to give to the object and purpose of the enactment of supplementing the written word if necessary - *Girdhari Lal & Sons v. Balbir Nath Mathur* AIR 1986 SC 1499 and *CIT v. J.H. Gotla* [1985] [156 ITR 323](#) (SC).

Interpretation - Tax treaties not in the same manner as domestic laws

4.3 A treaty becomes a tax statute the moment it is notified and becomes part of the Indian Income-tax Act, 1961, in terms of section 90 thereof. By such incorporation, it can be argued that, it has lost its superior status and falls to be construed in its context along with the rest of the law. It has to be qualified by those canons of interpretation as are normally applicable to taxation laws, *i.e.*, the words of the statute must be taken to mean what they say so that their meaning must be ascertained with no regard to ulterior consequences of so interpreting them. Viscount Simonds in the case of *Attorney-General v. Prince Ernest Augustus of Hanover* [1957] AC 436 said, "I reject, therefore, the argument in favour of restricting the meaning of the enacting words so far as it is based on any other consideration than that of the words of the statute itself".

The principles adopted for interpretation of treaties are not the same as those adopted for interpretation of statutory legislation. The interpretation of provisions of an international treaty, including one for double taxation relief, is that treaties are entered into in a political level and have several considerations as their bases (*Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#)). It should be done in the context of aiding commercial relations of the contracting parties.

Under the same general presumption that the Legislature does not intend to exceed its jurisdiction, every statute is to be interpreted and applied, so far as its language admits, as not to be inconsistent with the comity of nations or with the well-established rules of international law. If, therefore, it designs to effectuate any such object, it must express its intention with irresistible clearness to induce a Court to believe that it entertained it, for, if any other construction is possible, it would be adopted to avoid imputing such an intention to the Legislature. All general terms must be narrowed in construction to avoid it. But if the statute is unambiguous, its provisions must be followed, even if they are contrary to international law [*see Maxwell on the Interpretation of Statutes*, eleventh edition (1962) at page 42]. Doctrines as applied in interpreting domestic laws are also applied *viz.*, *generalia specialibus non derogant* (general words or things do not derogate from special or that when there is conflict between a general and special provision, the latter prevails), *unius est exclusio alterius*, *ejusdem generis* (of the same kind. Words of general nature following specific and particular words are construed as limited to things which are of the same nature as those specified), *ut res magis valeat quam pereat* (It is better for a thing to have effect than to be made void. A statute is supposed to be authentic repository of the legislative will and the function of the court is to interpret it according to the intent of them that made it), *verba accipienda sunt secundum subjectum materiam* (words are to be understood with reference to the subject-matter).

Interpretation - Tax treaties are special rules

4.4 Tax agreements are considered in India to be special provisions. They are not altered by subsequent law unless it expressly contradicts. They are the special rules. They, therefore, override the domestic laws on the doctrine of

generalia specialibus non derogant. This maxim is ordinarily attached where there is a conflict between the special and the general statute. It is subject to the provision that there is nothing in general provision expressed or implied indicating an intention to the contrary. In other words, to invoke the said maxim, the general and special rules shall occupy the same field—*CIT v. Shahzada Nand & Sons* [1966] [60 ITR 392](#) (SC). In case of conflict, the special provision must prevail - *Union of India v. India Fisheries (P.) Ltd.* [1965] [57 ITR 331](#) (SC).

Interpretation - Tax treaty is not an enactment

4.5 Though tax treaty on being notified becomes part of the Income-tax Act, 1961, it is unlike an enactment. It is not a statute. It is an agreement. It cannot, therefore, be interpreted as a statute. It has to be read in accordance with the rules of the public international law which favours liberal approach. A treaty is quite unlike any enactment, where the draftsmen have striven to express themselves with utmost exactness, tried to foresee all possible circumstances that may arise and to provide for them, sacrificed style and simplicity, forgone brevity, become long and involved. In consequence the judges have followed suit and interpret as apply to the circumstances covered by the very words, by giving them a literal interpretation. A treaty is different. It lays down general principles. It expresses its aims and purposes, in sentences of moderate length and commendable style, lacking precision. It, therefore, requires different pattern of interpretation. The Courts should not examine the words in meticulous details, argue about the precise grammatical sense. They should look to the purpose and the intent - *Bulmer Ltd. v. S.A. Bollinger* [1972] 2 All ER 1226. The approach is somewhat different.

Interpretation - Tax treaty, an approach

4.6 The treaty should be interpreted in a normal manner, unconstrained by the technical rules of law or precedents, on the broad principles of general acceptance—*Shipping Corporation of India Ltd. v. Gamlen Chemical Co. (Asia) Pty. Ltd.* [1980] 147 CLR 1429. Rigidity of the domestic precedent of antecedent date should not control its interpretation, for the sake of uniformity - *Stag Lines Ltd. v. Foscolo, Mango & Co.* [1932] AC 328. The following should be the approach of the Courts :—

1. It is necessary to look first a clear meaning of the words used in the relevant article of the convention, bearing in mind that consideration of the purpose of an enactment is always a legitimate part of the process of interpretation. A literal interpretation is inconsistent with the purposes of a particular article or of the treaty as a whole. If the provisions of a particular article is ambiguous, it may be possible to resolve the ambiguity by giving purposive construction to the convention looking at it as a whole by reference to its language as set out;
2. The process of interpretation should take into account the fact that the language of the treaty has not been chosen by Parliamentary draftsman. It is neither couched in the conventional English legislative idioms nor designed to be construed exclusively by the domestic courts. It is addressed to a much wider and more varied judicial audience than is an Act of Parliament which deals with purely domestic law. It should be interpreted, as Lord Wilberforce put it in *James Buchanan & Co. Ltd. v. Babco Forwarding & Shipping (UK) Ltd.* [1978] AC 141 "unconstrained by technical rules of English law, or by English legal precedent, but on broad principles of general acceptance";
3. The treaty should be interpreted in good faith and 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;
4. If the meaning of the relevant provision is unclear and ambiguous or leads to a result which is manifestly absurd or unreasonable, recourse may be had to supplementary means of interpretation;
5. Subsequent commentaries on a treaty have a persuasive value only, depending on the cogency to their reasoning;
6. Persuasive value of the decisions of the foreign courts on the interpretation of a treaty text depend on the reputation and the status of the court in question;
7. Aids to interpretation such as travaux preparatoires, international case law and the writing of jurists are not a substitute for study of the items of the treaty. Their use is discretionary, not mandatory, depending, for example, on the relevance of such materials and the weight to be attached to it.

(see *IRC v. The Commerzbank AG* and *IRC v. The Banco Do Brasil SA* [1990] STC 285)

Interpretation - Tax treaty rules

4.7 For interpretation of a tax treaty the courts have suggested the following rules :—

1. Tax treaty be read liberally is the basic rule. That rule is more easy to state than to apply. Following are the suggested practical rules;
2. When the terms of a tax treaty conflict with the provisions of the domestic law, the former prevail. (This has been discussed in detail in another chapter);
3. Tax treaty cannot create a charge which does not exist under the domestic Income-tax Act;
4. The object and purpose of the tax treaty may be taken into account;
5. Tax treaty be read as a whole;
6. Words in the tax treaty are to be read in their natural or ordinary sense;
7. The words not defined in the tax treaty be given meaning as under the domestic Income-tax Act, unless the context otherwise requires.

These are discussed in the following paragraphs :

Interpretation - Tax Treaty, Liberal Interpretation - Tax Treaty, Liberal

4.8 A treaty is not a legislation. Literal rule of statutory construction is, therefore, not applicable. It has to be liberally construed - *Shri Krishna Sharma v. State of West Bengal* AIR 1954 Cal. 591. The following are the reasons :

1. A treaty is drafted by diplomats, who do not use language in a precise legislative manner as the legal draftsmen do while drafting the statutes. They are not in the habit of using legal accuracy, but rather in adopting more liberal terms;
2. The treaty results from negotiation and compromise between two conflicting interests. The compromise is not drafted in the legalistic jargon;
3. Sometimes language in the treaty is intentionally or knowingly left vague and imprecise in order to achieve agreement;
4. The treaty is contractual in nature, formal ratification by Parliament as legislation notwithstanding.

A treaty results from deliberations and negotiations, in which none of the parties can expect without some concession to insist upon the country's interests, its language or the law. It is expressed in what is by tradition the language of the international intercourse. It is unreasonable to expect of it either nicety of scholarship or the exactitude of literary idiom. Neither the municipal law nor the technical terms of the negotiating countries can be expected to find place in its provisions. Where interests conflict, much must be allowed to the effects of the compromise. Where the principles, by which future action is to be guided, are laid down broadly, leaving to the concerned parties the actual measures to be taken in execution of these principles, it is unreasonable to expect greater precision than the circumstances admit of, or to reject incomplete provisions which are expressed without much detail and sometimes only in outline. On the other hand, it is necessary to discover and to give effect to all the beneficial intentions which such instruments embody and which their general tenor indicates. It is impossible to suppose, whatever the imperfections of their phrasing, that the framers of such instruments should have intended any party to escape its obligations by quibbling interpretation, by pedantic adherence to particular words, or by emphasizing the absence of the expressed words, where the sense to be implied from the purport of the treaty is reasonably plain - *The Blonde* [1922] 1 AC 313.

The accepted principle appears to be this. A taxing statute must be construed against either the revenue or the person sought to be charged, with perfect strictness - so far as the intention of the Parliament is discoverable. Where a tax convention is involved, however, the situation is different. A liberal interpretation is usual in the interest of the comity of nations. Tax conventions are negotiated primarily to remedy a subject's tax position by avoidance of double taxation rather than to make it more burdensome - *Gladden Estate v. The Queen* [1985] 1 CTC 163 (a Canadian case).

Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties and that a literal and legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated. We cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms [see *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) (SC)].

In construing the terms of the convention, it is proper to have regard to the fact that the conventions are apt to be more loosely worded than Acts of Parliament and that to construe a convention as Act indeed lead to a wrong interpretation being given to it - *Buchanan & Co. v. Babco Ltd.* [1978] AC 141. A purposive construction is to be given to the convention looked at as a whole, rather than a literal construction - *Fothergill v. Monarch Airlines* [1981] AC 251.

Thus, the courts in interpreting tax treaties apply more liberal principles than in the interpretation of domestic legislation, taking into account not only the requirement of Vienna Convention on the interpretation of treaties but also the context, object and purpose of the treaty (Thiel 90 ATC 4717; *Applicant A v. Minister for Immigration and Ethnic Affairs* (1997) 7 ALJR 381).

Tax treaty - Does not create a chargeTax treaty - Does not create a charge

4.9 A tax treaty cannot create a liability where it does not exist under the internal tax law. In other words, it does not impose additional tax liabilities. It is not a charging provision. Its aim is to avoid double taxation and to prevent fiscal evasion with respect to taxes on income, and not to charge income-tax.

No provision of the agreement can possibly fasten a tax liability where the liability is not imposed by the Act and if a tax liability is imposed by the Act, the agreement may be resorted to for negating or reducing it [*CIT v. R. M. Muthaiah* [1993] [202 ITR 508](#) (Kar.), *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) (SC) and *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#) (SC)].

Interpretation - Tax treaty object and purposeInterpretation - Tax treaty object and purpose

4.10 The basic rule, as aforesaid, is that the treaty be interpreted liberally. That is not to say that liberal construction be given without regard to the ordinary canons of construction. It means that it should receive as liberal an interpretation as will provide a true construction according to its language, object and intent and will not hinder the working of the international arrangement - *Thiel v. FCT* 89 ATC 4015. Ascertainment of the legislative intent is the guiding principle for the interpretation of a statute. The rule could not be different with respect to tax treaty. Legislative intent could be discovered from the purpose and object of the enactment; and, intent of the Contracting States, from that of the treaty. An agreement is best understood if we know the reason for it, its object and purpose. Lord Denning in *Bulmer Ltd. v. S.A. Bollinger* [1972] 2 All ER 1226 said that, "The treaty....is quite unlike any of the enactments we have been accustomed" and that,

"...It lays down general principles. It expresses its aims and purposes....what are English Courts to do when they are faced with a problem of interpretation? They must follow the European pattern. No longer must they examine the words in meticulous detail. No longer must they argue about the precise grammatical sense. They must look to the purpose or intent...."

This rule is also the general principle of the international law, now embodied in article 31(1) of the Vienna Convention on the Law of Treaties, that "a treaty should be interpreted in good faith and 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".

Interpretation - Tax treaty read as a wholeInterpretation - Tax treaty read as a whole

4.11 Terms are read in their context in the light of the object and the purpose of the treaty, is the basic principle of international law, as aforesaid. By "context" is meant the text of the treaty, its preamble and annexes and the agreements and instruments made by the parties in connection with the conclusion of the treaty. Giving effect to the expressed intention of the Contracting States as expressed in the words used in the light of the surrounding circumstances, in case of ambiguity, is the well-settled rule of interpretation. A search is made to discover and said intention. It could be done from the agreement itself, from its preamble, its provisions if read as a whole, its setting and pattern. The court duty is to give effect to the provisions of the treaty in their natural meaning; and not to interpret them in isolation. It is to be done in their context in the light of the object and purpose of the treaty. The context is thus very important. The fact that general words are used is not itself conclusive reason why every case falling literally within them should be governed by that enactment and the context of the enactment may well indicate that wide or general words should not be given restrictive meaning—see *Halsbury*, 4th edition, vol. 44, para 874. Words and particularly general words cannot be read in isolation; their colour and content are derived from their context - *Attorney General v. HRH Prince Augustus* [1957] 1 All ER 49. General words and phrases, therefore, however, wide and comprehensive they may be in their literal sense, must be construed as being limited to the actual objects of the enactment - *Chertsey, UDC v. Mixnam's Properties* [1942] 2 All ER 627 and *Central*

India Spg. & Wvg. & Mfg. Co. Ltd. v. Municipal Committee AIR 1958 SC 341. All general words are open to inspection and they demand inspection, to see whether they really bear their widest possible meaning - *Maunsell v. Olins* [1975] All ER 16. The qualification appropriate to the agreement is to be developed step by step from case to case - *Fothergill v. Monarch Airlines* [1980] 3 WLR 209. Every problem is unique, whatever the apparent similarities. Each situation requires an initial approach that dwells on its contextual needs.

In *Saunders v. M.N.R.* 54 DTC 524 it was said :

"Tax Conventions are negotiated primarily to remedy a subject's tax position by the avoidance of double taxation rather than to make it more burdensome. This fact is indicated in the preamble to the Convention. Accordingly, it is undesirable to look beyond the four corners of the Convention and the Protocol in seeking to ascertain the exact meaning of a particular phrase or word therein."

The above principle is also applied in reading a statute. Division of a statute into parts or chapters is a mere matter of convenience. The object of such division is not that each part or chapter should be read independently of each other or as a complete code by itself. It is a fundamental principle of interpretation that a statute must be read and construed as a whole, notwithstanding that every section in a statute is a substantive enactment in itself - *Laxminarain Gupta v. A.N. Puri* AIR 1951 Cal. 335. The ambiguity is resolved by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant legislative instrument.

Interpretation - Tax treaty words are read in their natural or ordinary sense

4.12 The words in the treaty are to be read in their natural or ordinary sense. The national court, in the interest of uniformity should construe rules formulated by an international convention, especially rules formulated for the purpose of governing international transactions in a normal manner, appropriate to the interpretation of international convention, unconstrained by technical rules of domestic law or precedent, but on broad principles of general acceptance - *James Buchanan & Co. Ltd. v. Babco Forwarding & Shipping (UK) Ltd.* [1978] AC 141, *Stag Line Ltd. v. Foscolo, Mango & Co. Ltd.* [1932] AC 328, *Shipping Corporation of India Ltd. v. Gamlen Chemical Co. Pty. Ltd.* [1980] 147 CLR 142, and *Theil v. FCT* 89 ATC 4015. If the natural or ordinary meaning is ambiguous or leads to an unreasonable result, other technique of interpretation may be resorted to discover the possible meaning. Such aids are the OECD/UN commentaries on the draft models, the decisions of the foreign courts etc. (discussed later).

Interpretation - Tax treaty - Words not defined in given meaning under the domestic Income-tax Act

4.13 A tax treaty is not drafted with precision. It is not couched in the conventional English legislative idioms. Some of the words and expression used in it are defined. Some others, not done. Such others have the meaning which they have under the domestic tax laws of the Contracting States. There is an exception. It is the context of the treaty. In that case contextual meaning is to be read.

Interpretation - Three approaches

4.13-1 There are three approaches to the interpretation of a treaty—

- textual,
- teleological and
- contextual

The textual approach requires the text of a treaty as the object of inquiry. The starting point is to give effect to the plain terms of a treaty or to construe words according to the general and ordinary meaning or their natural significance [see *IRC v. Commerz Bank AG* [1990] STC 285 (UK)]. The duty of the court is to decide what the law is and apply it and not to make it [see *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) (SC)]. A literal or legalistic interpretation is avoided when the basic purpose of the treaty might be defeated or frustrated [see *Gladden Estate v. R* [1985] 85 DTC (Canada)]. Thus, if read literally, absurd result follows or the purpose of the treaty is defeated or frustrated, literal interpretation is avoided. The courts usually adopt a liberal interpretation to give effect to the apparent intention of the contracting parties [see *Factor v. Laubenheimer* 290 US 276] and the purpose of the treaty [see *Estate of Burghardt v. Commissioner* [1983] 80 TC 705 (US)]. Intention of the parties

must be gathered from the language employed in the document (*see Rajkumar Rajindra Singh v. State of Himachal Pradesh* AIR 1990 SC 1833). The intention ought to be discovered in the treaty itself on the basis of its actual wordings. If the text is ambiguous, the discovery is made through the extrinsic sources. In *Crown Forest Industries Ltd. v. The Queen* [1995] 2 SCR 802 (Canada), the Court justified the use of extrinsic materials such as the Model Conventions and Commentaries. The courts should examine treaty provisions to ascertain and give effect to the intention of the contracting parties as expressed in the words used by them (*see Stickle v. MNR* [1972] FC 672 (Canada)). The intention approach is valid where there is ambiguity in the text and the primacy to the express term is lost. The intention is left to implication. Such implication should not be external to the treaty itself and has to be gathered from it. The implied or the presumed intention is as much part of the treaty as if it sets forth therein in express terms. Under the general law relating to a document, the proper construction is of the written words themselves, set in their surrounding circumstances or matrix, and without paying any regard in this task of interpretation to any evidence from the parties or any one else, as to what they thought the document meant or intended to mean. Implied term is the product of the court's interpretation, which in the opinion of the court, the parties had intended or which the law implies. The law is not different for a treaty. If the text of a treaty is plain and unambiguous, that is the end of the matter. But where it is not, extrinsic sources are resorted to discover the intention. The "intention" approach includes presumed intentions of the parties.

The teleological approach emphasis the need to ascertain the object and the purpose of a treaty in order to give effect to it.

The International Court of Justice generally follows the textual approach, and also pursues the "intention" or the "teleological" approach in case of necessity. It once observed :

"The Court considers it necessary to say that the first duty of a Tribunal which is called upon to interpret and apply the provisions of a treaty, is to endeavour to give effect to them in their natural and ordinary meaning in the context in which they occur. If the relevant words in their natural and ordinary meaning make sense in their context, that is the end of the matter. If on the other hand, the words in their natural and ordinary meanings are ambiguous or lead to an unreasonable result, then and then only, must be Court, by resort to other methods of interpretation seek to ascertain what parties really did mean when they used these words. As the Permanent Court said in the case concerning the Polish Postal Service in Danzing (P.C.I.J., Series B. No. 11, p. 39) :

It is a cardinal principle of interpretation that words must be interpreted in the sense which they normally have in their context, unless such interpretation would lead to something unreasonable or absurd.

(*See Competence of the General Assembly for the Admission of a State to the United Nations*, Advisory Opinion, I.C.J. Reports 1950, p. 4 at p.8)

The courts takes a liberal approach.

These could be read in article 31 of the Vienna Convention of the Law of Treaties, 1969. According to that Convention (*see para 4.16*), a treaty is to 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. The expression "in their context" was defined as including any agreement between the parties relating to the treaty or any other instrument made by one party and accepted by the other. The context therefore includes protocols, reservations made by the parties in connection with the treaty, and other mutual agreements considered as subsequent agreements. As for mutual agreements under article 25 of the Model Convention, these should be of the nature of general agreements and not those arrived at in particular circumstances of an individual case.

Interpretation - Tax treaty, contextual interpretation - OECD Commentaries

4.14 Interpretation starts with consideration of the text. The text expresses the intention of the parties to the agreement. If the text is not clear, recourse is had to extraneous sources, to discover such intention. Discovery of the intention is the basic rule of interpretation. Interpretation must, therefore, depend on the text and the context. If the text is the texture, the context is what gives the colour. That interpretation is best which makes the textual interpretation match the contextual. Text and the context are the internal aids. OECD/UN Commentaries are the external aid. They are important source of interpretation. The courts have been relying upon them - *United States v. A.L. Burbank & Co. Ltd.* 525 F 2d 9. *Theil v. FCT* [1990] 21 ATR 531 (Australia) and *Crown Forest Industries Ltd. v. The Queen* [1995] 95 DTC 5389 (Canada). This is consistent with Vienna Convention. If the text of the OECD

Model has been adopted unchanged, it is to be assumed that the Contracting States intended to conform the commentary.

The Andhra Pradesh High Court in the case of *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#), referred to the OECD Commentary on the technical expressions and clauses in the model conventions, and referred to, with approval, Lord Radcliff's observation in *Ostime (Inspector of Taxes) v. Australian Mutual Provident Society* [1960] 39 ITR 210, 219 (HL) which have described the language employed in those documents as the "international tax language". These documents are thus in the nature of *contemporanea expositio* inasmuch as the meaning indicated, in these documents, to the clauses and expressions in the tax treaties can be inferred as the meaning normally understood in, to use the words of Lord Radcliff, "international language" developed by the organisation like the OECD. This is so held in the case of *Graphite India Ltd. v. Dy. CIT* [2003] [86 ITD 384](#) (Kol.)

The ITAT held as follows in *Metchem Canada Inc. v. Dy. CIT* [2006] 284 ITR (AT) 196 (Mum.) observed (Head note) :

"Article 24 of the Double Taxation Avoidance Agreement between India and Canada is the verbatim extract of the OECD Model Convention. This Convention has a key role in determining the scope and connotations of article 24(2). When an expression or a clause is picked up from the OECD Model Convention, the normal presumption is that the persons using the said clause or expression are also aware about the meanings assigned to the said clause or expression by the OECD and have used it in the same sense and for the same purpose. Unless a contrary intention is specifically expressed, it is only axiomatic that the clause or the expression will have the same meaning as normally assigned in the tax literature by the OECD. Therefore, when an expression or a clause for the OECD Model Convention is used even in a bilateral tax treaty involving a non-OECD country, one has to proceed on the basis that it is used in the same meaning and with the same connotations as assigned to it by the OECD Model Convention Commentary."

The above decision is supportive of the OECD Model Convention and Commentaries. Commentaries are referred to as a guide to the interpretation of a treaty (*see Sun Assurance Co. of Canada v. Pearson* [1984] STC 461 (UK) and provide some assistance in discerning the legal context surrounding double taxation conventions (*see Cudd Pressure Control Inc. v. The Queen* [1999] CTC 1 (Canada)).

Such commentaries do not form part of the text of a tax treaty. They may form travaux preparatoires in the same manner as "legislative history" forms part of a legislative enactment. (Travaux preparatoires is a term that designates those intrinsic materials which had the formative effect on the final draft of a treaty, and which, therefore, assist in the disclosure of the parties aims and intentions). A treaty is the result of negotiation spreading over a long period of time. The final draft owes its origin and actual wording to some prior treaty-preparing process. Reference to travaux preparatoires as an aid to interpretation has been recognised by the Vienna Convention on the Law of Treaties of 1969. Articles 31 and 32 thereof codify the already existing practice of such reference by the national courts. The courts are entitled to consider the OECD commentaries in determining the construction of a treaty - *Fothergill v. Monarch Airlines Ltd.* [1981] AC 251 and *Sun Life Assurance Co. of Canada v. Pearson* [1986] STC 335 and *Theil v. FCT* 89 ATC 4015. But the Indian Courts do not give much importance to commentaries as a safe or acceptable guide or aid for construction [*see CIT v. V.R.S.R.M. Firm* [1994] [208 ITR 400](#) (Mad.) affirmed by the Supreme Court in *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#) (SC)].

Interpretation - Tax treaty and the Indian Constitution

4.15 Treaties are interpreted in the sense in which the parties to it are internationally committed to understand, unless law forbids. A contract should not be construed as a statute as overriding international law, unless compelled by its words - *Maharaja Bikram Kishore v. Province of Assam* [1949] 17 ITR 220 (Cal.). Such is also the requirement of Indian Constitution. Its article 51(c) provides that the State shall endeavour to foster respect of international law and treaty obligation in the dealings of organised peoples with another. Internationally accepted principles of interpretation of treaties are, therefore, applied by the Indian Courts. They are under constitutional duty to do so.

Interpretation - Tax treaty and Vienna Convention

4.16 The principle of treaties between nations is contained in the 1969 Vienna Convention. Article 31 provides the general rule :

1. A treaty is 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.
2. The context for the purpose of interpretation of a treaty shall comprise, in addition to text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context :
 - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

The rules of interpretation of treaties are contained in articles 31, 32 and 33 of the Vienna Convention of the Law of Treaties, 1969. Article 31 embodies the general rule; article 32, deals with supplementary means *i.e.*, the aids of interpretation; and, article 33, with interpretation of treaties authenticated in two or more languages. These articles are, however, not complete code. The rules of customary international law govern questions not regulated by the provisions of the Convention. Good faith, textual, and contextual approach is the crux of article 31. The treaty is binding upon the parties and must be performed by them in good faith (*pacta sunt servanda*). Treaty language is of primary importance, according to Vienna rule. The words must receive "usual meaning", in the context of the entire agreement. The intent of the parties is not as important. It is important to the extent that it is found expressed in the text.

Interpretation - Tax treaty - Common interpretation (decisions of foreign courts) Interpretation - Tax treaty - Common interpretation (decisions of foreign courts)

4.17 Treaties are meant to allocate tax claims between Contracting States. This could be achieved, if the treaty is applied consistently by the authorities and the courts of both States. In interpreting, an interpretation should be sought which is most likely to be accepted in both contracting States. Inconsistencies with the decisions should be avoided because they result in double taxation - *Canadian Pacific Ltd. v. The Queen* 76 D Tax 6120. Foreign decisions are followed as if binding. Lord Denning said in *Corocraft v. Pan American Airways* [1968] 3 WLR 1273, "even if I disagree, I would follow them in a matter which is of international concern. The courts of all the countries should interpret this convention in the same way". Thus, for the efficient and fair interpretation, attempt should be to interpret the treaty consistently avoiding collision. Decisions of the foreign courts, though not binding on the domestic courts may have a persuasive influence on them. These courts should persuade themselves in accepting them and interpreting them in the same way as far as possible. It does not, however, mean that the court should surrender their judgment completely to the foreign decision and follow it blindly even if it contains inconsistencies. The persuasive value of a decision depends on, among other things, on the reputation and rank of the foreign court in question - *Fothergill v. Monarch Airlines* [1980] 2 WLR 209. It does not command more respect than the decision of another court of equal competence in the same country.

In *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#), the Andhra Pradesh High Court observed:

"In view of the standard of OECD models which are being used in various countries, a new era of genuine 'international tax law' is in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adaptation is just as important as the initial removal of divergences. Therefore, the judgments rendered by the courts in other countries or rulings given by other tax authorities would be relevant."

Roy Rohtagi in his book on "Basic International Taxation" (Second Edition) at page 59, at foot note 189 gave examples where foreign decisions are applied by the domestic courts :

"189. Examples : A Dutch interpretation was used in Canada in *Hunter Douglas v. MNS* 79 DTC 5340 : UK and Canadian decisions were applied in Australia in *Theil v. FCT* 90 ATC 4717; a German decision was applied in New Zealand in *CIR v. United Dominions Trust Ltd.* [1973] 1 NZTC 61028; a Canadian decision was applied in *United States in Donroy Ltd. v. US* [1962] 301 F. 2d 200; a German decision was applied in India in *CIT v. Vishakhapatnam Port Trust* [144 ITR 146](#) , 157-158; a United States decision was applied in Canada in *No. 630 v. MNR* 59 DTC 300; etc."

The foreign decision, however, cannot be placed at the same pedestal as that of the Supreme Court of India, whose verdict prevails over and is binding on all the lower courts in India, in terms of article 141 of the Constitution.

Interpretation - Tax treaty rules are ‘rules of limitation of law’

4.18 The double taxation agreement between the two Contracting States do not provide for the application of tax laws of one State by the other State. The purpose of these is to limit or restrict the application of domestic laws with a view to avoiding double taxation or preventing fiscal avoidance. Rules of double taxation agreements are, therefore, ‘rules of limitation of law’. These operate either to exclude application of the domestic law of one of the States where it would otherwise apply or to oblige the State to grant credit against its own tax in respect of taxes paid in the other State. A tax obligation exists as prescribed by the domestic law of the State, but only to the extent as confined or defined by the tax agreements. Thus, the tax agreement rules are formulated separately and independently of domestic laws and have independent origin or legal foundation. In their effect and origin these are comparable to ‘international administrative law’ as the tax agreement rules are ‘rules of limitation of law’. Tax agreements, unlike conflict rules in international law, do not choose between domestic and foreign law. Each State applies its own domestic law. The tax agreement rules limit the Contracting States’ application to that law. The limitation may consist of the waiver of tax claim in favour of the other State (exemption method) or of granting credit of tax paid in the other State against the tax due in accordance with the domestic laws (credit method). The statutory words apparently unlimited in scope may be given a restricted field of application if there is admissible ground for importing such a restriction; and the consideration that, if not construed in some limited sense, they would amount to breach of international laws is well recognised as such a ground - *Collico Dealings Ltd. v. CIR* [1961] 1 All ER 762.

Interpretation - Tax treaty legal and other terms have different connotation in the Contracting States

4.19 When an expression has not been defined in an agreement or has been defined loosely or inadequately, controversy about what it connotes may arise in relation to the agreement if it is understood or interpreted differently under the domestic laws of the Contracting States. This controversy becomes more pronounced when the agreement uses legal terms which are also the terms of the substantive law of Contracting States. It may relate to whether income received as dividend or interest or from property could be said to have been done from carrying on business and computed accordingly or be said to have been done from investment in shares, bonds and securities or from immovable property and, therefore be computed under the respective articles of the double taxation agreement; or whether remuneration paid to an orchestra conductor for recordings is a royalty under article 12 of the OECD Model or compensation for personal services; or whether a commission agent or trading agent carries on a business or has income from independent personal services; or whether interest paid to a partner of the firm constitutes business profits of the partner or represents interest income, and so on. These illustrations are reflective of the conflict which may appear when such issues are dealt with within the jurisdiction of the Contracting States in accordance with their domestic laws in the absence or adequacy of an express definition of various terms and expressions. The conflict is resolved in the manner as discussed in the following paragraphs.

Characterisation

4.19-1 The conflict lies in the mind of the tax authorities as to which system of law applies to the facts before them. The tax agreements do not provide that the State must apply domestic or foreign law, but rather impose their own rules in addition to the laws of the Contracting States. In the absence of an express definition of an expression or a term in any agreement, always a question of characterisation (qualification or classification to some writers) arises. Characterisation refers to the situation in which the Contracting States attach different interpretations to the term under their domestic laws. The problem of characterisation is resolved through various theories and concepts which are discussed below.

Lex fori (Law of the court)Lex fori (Law of the court)

4.19-2 This expression means the local or the domestic law of the country to which a Court wherein the action is brought, or other legal proceedings are taken belongs. (Decey's Conflict of Laws, Seventh Edn., P. 40). According to this doctrine, each State qualifies the agreement terms according to the requirements of its own domestic law. The main argument in favour of this doctrine is that if a foreign law is allowed to determine in what circumstances it is to be applied, then the domestic law would lose its control over the application of its own conflict rules. The tax authorities, courts and the subject are well conversant with and they understand their own law best, as evidenced by statute books or established by courts. Its subjugation to the foreign law can be permitted to the extent an agreement permits. The absence of the express definition of an expression or term will not subordinate the sovereignty of State as to interpret it in the manner as dictated by the foreign law.

The argument against it is that its application in complete disregard to the foreign law may not result in arriving at a conclusion for a situation, which is not intended by the agreement or which is against its objects and purpose; such as retaining certain types of taxation that the agreement intends to avoid or creating a situation where an income cannot be taxed in either of the States. The former result could be avoided through mutual agreement while the latter could not be so avoided as there could be no possibility of double non-taxation agreement.

Lex causeLex cause

4.19-3 This expression means that every legal rule takes its classification from the legal system to which it belongs. According to it both states apply the terms as defined in the domestic laws of the source State. The Contracting States should interpret the terms and expressions of the agreement in accordance with our domestic laws in regard to income which accrues or arises in their States respectively. The principle is also sometimes called 'source country qualification'. Norwegian Supreme Court in *Alaska* (Hoyesterett Rt 1984 at 99) held the view that the law of the source State should be applied. In that case, the remuneration of three Norwegian fishermen who were fishing outside Alaska was treated as income for personal services because they were classified as employees according to the US laws. Norwegian tax authorities respected that classification and allowed credit of the tax paid in the US against the taxes calculated by them by classifying the income as "business profit". Recognition to it is given in the agreement itself when article 3(2) of the OECD Model states, *inter alia*, that in application of the provisions of the agreement by a Contracting State, the terms which have not been defined in it will have the meaning which they have under the laws in force in that State or when it provides for taxation of income from immovable properties according to their location.

For example, article VI(2) of the agreement between India and Kenya leads to taxation in India of the sale proceeds both with respect to an Indian real property of a company with Kenyan shareholders under article XIV(1) of the agreement, and with respect to a Kenyan real property of holding company with Indian shareholders, under article XIV(4). Similarly, if a lump sum amount is paid by an Indian company to its former manager who has been resident in Kenya, it is taxable in India as such payment constitutes 'income from services', and is also taxable in Kenya under article XXI. The event which is responsible for the arising of income is likely to be looked upon and interpreted by the tax authorities and the courts of India in such a manner as to hold that the entire income becomes taxable in India, quite oblivious of the possible claim of the Kenyan authorities if that event is read in context of the other article of the agreement. They would perhaps be unwilling to distribute the event equally between India and Kenya. The emphasis is on the 'source' and the concept of 'residence' is likely to be relegated into oblivion, whereas traditional approach of the tax agreements is to lay emphasis on 'residence' rather than the source, for the taxability of income. The concept of 'residence' therefore finds an elaborate discussion in the all tax agreements providing for how to determine the residential status of the recipient of income under all circumstances, which possibly could exist. In case conflict still persists, it is resolved on the basis of mutual agreement procedure.

Conflict - ResolutionConflict - Resolution

4.19-4 None of the above methods is sufficient. The choice depends upon the purpose for which interpretation is sought. Sometimes a combination of these is resorted to, if the context so requires. The method which conforms to the character of the agreement as an independent rule must apply. The rules are only aids to constructions, presumptions or pointers. Not infrequently one 'rule' points in one direction, another in a different direction. In each case we must look at all relevant circumstances and decide as a matter of judgment what weight to attach to any particular rule. *Mounsell v. Olins* [1975] 1 All ER 16, as per Lord Reid.

Interpretation - Ambulatory Interpretation - Ambulatory

4.20 The terms of treaty are to be interpreted in accordance with the law when the tax case arises and not when the agreement was signed. It may be presumed that the States intended the agreement to be applied at any future time in such a way as to give effect to the true original intention. The agreement of former days is to be read today with such modification of the current meaning of its language as will now give effect to the original intention. Its language, though necessarily embedded in its own time, is to be interpreted in accordance with the need to treat it as a current law. The agreement is to be interpreted on the same manner as an ongoing Act is done, as always speaking.

Many countries favour ambulatory approach (see *Estate of Burghardt v. Commissioner* 80 TC 705; [1983] aff'd 734 F.2d 3; [1984] (US), *Ducking v. Gollan* [1965] 42 TC 333 (UK) and do not approve the approach of the Canadian Supreme Court decision in *The Queen v. Melford Developments Inc.* [1982] CTC 330. That case dealt with the issue whether guarantee fees could be considered "interest" under the treaty between Canada and Germany. The Court ruled in favour of the taxpayer. It held that the definition of "interest" at the time of treaty was concluded was to be applied. The Canadian Minister of Finance responded by tabling corrective statutory law, which establishes the ambulatory principle of interpretation.

Ambulatory interpretation should not, however, affect the substance of the treaty or its general principles, as otherwise it would mean unilateral modification of treaty which is impermissible.

Interpretation - Parallel treaties Interpretation - Parallel treaties

4.21 A treaty is an agreement between two States. On the same subject there may be a similar treaty between one of them and a third State or between two other different States. Such treaties are parallel treaties and may provide guidance for the interpretation of other treaties especially when they are based on OECD/UN Model Convention. Model-based treaties create a pattern in tax-treaty practice. Treaties using the same terms are intended to convey the same meaning. Sometimes for the sake of clarity or abundant precaution an expression is further qualified. Such qualificatory words do not add to the meaning or content. Their absence in another treaty would not mean that the expression does not convey the same meaning. For example, Indian treaties with the UK, Netherlands, Canada, Denmark, France, Norway use the term "warehouse" in article 5(2) with the words "in relation to a person providing storage facilities for others". The omission of the additional words in other treaty, for example with Belgium, Finland, Germany, cannot be interpreted to mean that the warehouse cannot constitute a PE as a place through which the business is carried on.

The contrary however, may not be true. The absence in a treaty of a rule expressly contained in another is not interpreted that the rule is not applicable. However, the Supreme Court of India in *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) found merit and accepted the argument that absence of a limitation clause as the one contained in article 24 of the Indo-US treaty in the Indo-Mauritius treaty there is no disabling or disentitling conditions under the Indo-Mauritius treaty prohibiting resident of a third nation deriving benefits thereunder. The absence of limitation of benefit clause, among other things, led the Supreme Court to hold "Despite the sound and fury of the respondents over the so-called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when the Indo-Mauritius DTAC was entered into." The absence of limitation of benefit clause led to the interpretation that treaty shopping was not prohibited under the Indo-Mauritius treaty meaning that a resident of a third state can take benefit of the treaty despite of the express dictate of article 1 that "This Convention shall apply to persons who are residents of one or both of the Contracting States."

Interpretation - Administrative directions Interpretation - Administrative directions

4.22 It is a well settled principle of interpretation that courts in construing a statute will give much weight to the interpretation put upon it, at the time of enactment and since, by those whose duty it is to construe, execute and apply (see *Baleshwar Bagarti v. Bhagirathi Dass* [1908] ILR Cal 701 and *Deshbandhu Gupta & Co. v. Delhi Stock Exchange Association Ltd.* [1979] 4 SCC 565). The circulars and instructions issued by authorities are in the nature of *contemporanea expositio* furnishing legitimate aid to the construction of the Act [see *K.P. Varghese v. ITO* [1981] [131 ITR 597](#) (SC)]. The rule of *contemporanea expositio* is that administrative construction (i.e., contemporaneous construction placed by administrative or executive officers charged with executing a statute) is commonly referred to as practical construction, although non-controlling, is nevertheless entitled to considerable

weight, it is highly persuasive (*see* Crawford on Statutory Construction). The same principle is applicable with respect to treaties.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - CLASSIFICATION AND QUANTIFICATION OF INCOME

IntroductionIntroduction

5.1 As discussed in chapter 3 that where a matter is governed by the provisions of the Income-tax Act, 1961, and also by the Double Taxation Agreement (DTA), the provisions of the DTA should prevail unless the statutory provision is more beneficial to the taxpayer—*see* section 90(2) of the Income-tax Act, 1961, Circular No. 333, dated 2nd April, 1982 issued by the Central Board of Direct Taxes [1982] 137 ITR (St.) 1 and the decision of the Madras High Court in *CIT v. V.R.S.R.M. Firm* [1994] [208 ITR 400](#) . It was also discussed that the DTA does not create a charge on income. It only limits the application of the provisions of the Act. There are three stages of tax liability. There is a declaration of liability, that is to say, the statute determining who persons, in respect of what property, are liable. The DTA does not create the liability. The Income-tax Act creates the charge. Next, there is the assessment. Assessment particularises the exact sum which a liable person has to pay. The Act provides the procedure. It also provides the mode of computation. That mode is modified by the DTA. Lastly, comes the method of recovery, if the person does not voluntary pay. The Act provides detailed procedure for effecting recovery. The DTA does not define, and create charge on, income. It, however, classifies.

Double Taxation Agreement and Income-tax Act SchemeDouble Taxation Agreement and Income-tax Act Scheme

5.2 The scheme of the Indian Income-tax Act, 1961 is to create a charge (section 4), define (section 5), classify (section 14) and quantify (sections 15 to 59) income. The DTA does not create a charge and define income. It, however classifies, and quantifies in specified cases. Income-tax is only one tax on the sum total of the income classified and chargeable under the various heads of income, *viz.*, salaries, income from house property, profits and gains of business or profession, capital gains, and income from other sources such as dividend, interest, directors' fee, and other not falling under any of the preceding classification. The effect of such classification is to provide for each head appropriate rules for computing the amount of income. The DTA also classifies income; salary (articles 15 and 19 of the OECD Model), pensions (article 18), immovable property (article 6), business profits (articles 5, 7 and 9), profits from transport business (article 8), professional profits (article 14), capital gains (article 13), dividends (article 10), interest (article 11), royalties (article 12), directors' fee (article 16) other income (article 21). Article 17 deals with income of artists and athletes, and, article 20, payments to students. Article 22 deals with taxation of capital. These articles have dual purpose. They limit the right of the State with respect to the income thus classified. They also provide for special rules for computation and in some cases lay down the rate of tax. Business profit of a foreign enterprise is taxable in the state of residence if only it carries on business in India through a permanent establishment. Only so much is done as is attributable to that permanent establishment. There are several rules provided in article 7 for computation of business profits. Special provisions have been made for taxing certain categories of business expenditure. Article 8 deals with the business of air and shipping transport. Article 9 deals with associated companies. Various reliefs have been provided as to the rate of tax and also computation of quantum of business profits. The same pattern is available for taxing professional profit. It is taxable only if the non-resident has a fixed base regularly available to him. Only so much is taxed as is attributable to that fixed place (article 14). Exception is the income of the artistes and athletes (article 17). It is taxable in the State where personal activities as such are exercised. Income from employment (salaries) is dealt in article 15. It is not taxable in the state of residence if the employment is exercised in another State and the recipient is present in that State for a period exceeding 183 days, and remuneration is paid by an employer who is resident of that state or is borne by a permanent establishment or a fixed base which the employer has in that State. Exceptions are

directors' fee (article 16), pensions (article 18), and remuneration from Government service (article 19). Such income is taxable in India if the recipient is the resident of India or if the remuneration (other than the pension) is paid by the Indian Government. Article 20 exempts from tax payments received by students and apprentices in certain circumstances, altogether. Dividend is taxable at a concessional rate under special circumstances (article 10). Interest is dealt with in article 11. The manner of taxation at a special concessional rate of tax is laid down therein. Similarly royalties and fees for technical services are dealt with in article 12. The gross amount is taxed and upper limit of rate of tax, provided. Article 13 contains rules of computation of capital gains. Total income of a non-resident assessee is computed in India under the Income-tax Act, 1961, after giving the benefits of the abovementioned articles. Thus for determination of income or profits of a non-residents which are taxable in India, the principles as enunciated under that Act and done under the DTA have to be analysed.

Principles of taxation - Effect of classification Principles of taxation - Effect of classification

5.3 The effect of classification under the DTA, as aforesaid, is to provide rules for computing income for each category and to limit the rights of the States with respect thereto. Taxability of income is considered under the appropriate classification alone and if it cannot be so taxed because of the non-satisfaction of the requisite requirement, it cannot be taxed under another classification. If for an income an appropriate head is business and it cannot be so charged because the foreign enterprise does not have a permanent establishment in terms of article 5, it cannot be labelled differently and taxed in the source State. This matter was discussed in detail in advance ruling in *Horizontal Drilling International v. CIT* [1999] [103 Taxman 447](#) (AAR - New Delhi). It was a case under the India/France treaty. It was held (head notes) :—

"In the present case, the applicant is carrying out a project for the installation of a underground pipelines for the GAIL. If this project has lasted beyond six months, the profits arising to the applicant therefrom would have been chargeable to tax in India by virtue of article 7 as part of its business profits. However, the projects has not lasted that long-long enough for it to be considered as its PE in India. The resultant inference would be that its profits cannot be charged as "business profits" in view of the absence of a PE in India.

Paragraph 6 of article 13 intends to take out of its purview items that would be normally and more appropriately assessable under other specific article such as article 7 or article 15. It would not be correct to charge such profits under article 13 in cases like the present where there is an establishment of the nature envisaged in article 5, only chargeability under article 7 fails because the duration of such establishment does not extent beyond the period stipulated in article 5(3). To read the clauses would result in an anomaly that the business profits of a non-resident which are intended to be chargeable only where the non-resident has a PE in India would become chargeable to tax even where it has no PE merely by labelling them as consideration for technical services. There will also be the anomaly that such receipts would become taxable on their gross amount without any deduction for expenses laid out for earning them, a deduction which would have been available had the charge been made under article 7. Thus, if the contract in this case had lasted for six months or more, tax in India could have been charged only on the net receipts whereas, because of the shorter duration, this benefit will be lost to the applicant on the interpretation suggested by the Department. It is difficult to read these implications into the wordings of the two articles.

In the above situation, a more apposite construction would appear to be to read the two articles harmoniously and include within the definition in paragraph 4 of article 13, only payments made in consideration for services *qua* services and correlated thereto and excluding from its purview payments made in consideration of the execution of a construction or installation project or the like referred to in paragraph 3 of article 5."

Classification of e-commerce payments Classification of e-commerce payments

5.3A As aforesaid, different treatments may apply to different categories of income. It depends upon the nature as also where it arises. Tax treaties could allocate tax revenues among the source and the residence States on determination of the source of income and location of the gross profits. Where the gross profits arise, was only required to be determined. The test to be applied was to see what the taxpayer has done to earn the profit and where he has done it. "What" and "where" the taxpayer has done, are its characteristics. It depends on physical presence. The concept of physical presence is antithesis of e-commerce. The ability to generate income without physical presence is its hall mark. It is difficult to locate "where" in respect of digital goods and service transactions, and consequently, divide taxing authority between the residence and the source States. There may be problems where the Contracting States differ on the meaning of the source and residence concepts; for example, in case of a server. Suppose a resident of State R has a server in State S, the State S holds the presence of the server as the presence of

the permanent establishment and thereby a right to tax business profits. The State R does not agree that the server is a permanent establishment.

The internet eliminated the need of the people to be physically present to do business. Electronic transactions do not have respect for the concepts of physical presence of the business and the geographical location of income. Presently, under the treaty these concepts play an important role in allocating jurisdiction between the contracting States and income from business, performance of services, royalties, dividends and interests are treated differently with regard to the manner of computation and rate of tax. Income from business and services is taxed on net basis and other, on gross, at the rate as prescribed under the domestic law in the case of the former and as laid down in the treaty itself in the latter. What is required to be ascertained are:—

- First, what is the nature of income *i.e.*, whether it is interest, dividend, trading profits, royalty etc.;
- Secondly, the originating cause *i.e.*, what has been done to derive the income ;
- Thirdly, the geographical location of the originating cause.

In the case of e-commerce transactions, all these determinations are difficult.

In a case before the Authority for Advance Rulings, New Delhi, AAR No. 390 of 1997 (28 April, 1997), a question arose whether the fees paid by an Indian company [India Card Ltd. (IC)] to a USA Company [U.S. Card International (USCI)] of which the Indian company was the subsidiary, for the use of the Hong Kong network and the processing centre in the United States is taxable in India on royalties received for the use of its software. Under the Indo-US treaty the withholding rate of tax on gross amount of royalty income was between 10 and 20%. It was argued by the US company that the payments received from the IC were business profits not taxable in India because that company had no Indian permanent establishment. According to it, the payments were the compensation for services for the use of its software and what the IC acquired was the output of the processed data rather than any rights in the processing of data. These were its business and not royalty income. The Authority did not agree. It concluded that IC paid for the right to use software and thus the amount represented royalty income in terms of article 12 of the treaty.

The payment related to the software. The controversy was whether it was for the use of the processed data or the right to use the software. If it is the one, it is business income and, if the other, royalty. The applicant urged the former, while the Authority held, latter. The matter whether receipt relating to software is business or royalty income has been discussed in detail in paragraphs 18.11-1 and 18.11-2.

The ruling is indicative of possible conflict between States about the characterisation of a receipt. There is no international consensus.

The following three principal technical issues were addressed in the Report of the OECD Technical Advisory Group on the Characterisation of Electronic Commerce Revenue for the International Income-tax Purposes (Appended at the end of the chapter):—

1. Electronic delivery of software, music, video or other digital products - whether business profits or royalty income;
2. Electronic commerce transaction involving the provision of technical fee - whether business profit or technical fee;
3. Electronic commerce transaction involving payments for the use of industrial, commercial or scientific equipment - whether provision of services or transfer of property

These issues require resolution between :

1. Business profits *v.* royalties,
 - copyright royalties
 - know-how
 - payment for the use of industrial, commercial or scientific equipment;
2. Business profits *v.* technical fees,
3. Provisions for services *v.* transfer of property,

and are discussed in detail in the said Report. Its conclusions are summarised below.

Business profits and copyright royalties - Software

One of the most important issues arising from e-commerce is the distinction between business profits and royalties as defined in the treaty. The expression has been defined, *inter alia*, to mean the payments for the use of, or the right to use, a copyright. Whether downloading a computer programme from internet is royalty income, depends upon the identification of the consideration of the payment. Where the consideration is for something other than rights in the copyright (such as other types of contractual rights or such as data or services), and the use of the copyright is limited as are required to enable downloading, storage and operation on the consumer's network, such use of right should be disregarded in the analysis of the character of the payment for tax purposes.

This would be the case where a payment is made by a person for the downloading and the operation of the copy of the computer programme. The granting of rights in relation to the downloading and storage processes, where they do no more than enable the effective utilisation of the programme by the customer, would be merely incidental and accessory part of the transaction. The OECD has already addressed the treatment of electronic deliveries of computer software programmes in its commentary on Article 12 of the OECD Model Tax Convention. It provides that such delivery should be treated as the same as the physical delivery of the same programme, because "the method of transferring the computer programme to the transferee is not relevant. For example, it does not matter whether the transferee acquires a computer disk containing a copy of the programme or directly receives a copy on the hard disk of her computer *via* modem connection." The Report concluded that computer software programme to a consumer will give rise to business profits rather than royalty income. [This view is not consistent with the view taken by the Indian Authority for Advance Ruling (AAR No. 390 of 1997, 28 April, 1997). It is because the Indo-US treaty permits source State taxation of royalties. Article 12 of the OECD Model, however, does not so permit. So whether the payment in question is characterised by the source State as a royalty initially addressed by Article 12 or as business profits addressed by Article 7, there is no source State taxation unless the payment is attributable to a permanent establishment in the source State].

Business profits and copyright royalties - Digital products

As regards digital products other than the software (such as images, sounds or text), it is to be ascertained whether the downloading is for the acquirer's own use or enjoyment. In that case payment is not royalty, as in the case of software downloading.

Business profits - Know-how royalties

Whether the consideration for a payment is the provision of services or the provision of know-how (*i.e.*, information concerning industrial, commercial or scientific experience), depends upon identification of elements of know-how in the transactions. Know-how is undivulged technical information that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience. Know-how represents what a manufacturer cannot know from mere examination of the process and mere knowledge of the process of the technique.

The provision of know-how is distinguished from the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. The following payments are considered as consideration received for the provision of services and not of know-how :—

- payments obtained as consideration for after-sales service;
- payments for services rendered by a seller to the purchaser under a guarantee;
- payments for pure technical assistance;
- payments for an opinion given by an engineer, an advocate or an accountant.

On-line advice, communications with technicians and using the trouble-shooting database, involve actual services being performed on demand rather than the provision of know-how.

The payment could be characterised as business income.

Business profits - Use of, or the right to use, industrial, commercial or scientific equipment

The expression "royalties" has been defined in article 12 of the UN Model as to include payments for the use of, or the right to use, industrial, commercial or scientific equipment. Whether the payments for the use or the right to use the following digital product (time-limited use) or the computer equipment are to be taken as business profits or the royalties, is a question which has been receiving attention of the experts:—

1. Digital products (time-limited use);

2. Computer equipment.

Time-limited use of the digital products

Time limited use of the digital products means when a person receives the right to use software and other products for a period of time that is less than the useful life of the product. The product could be downloaded electronically or delivered on a tangible medium such as a CD. All copies of the digital product are to be deleted or become unusable upon termination of the licence. Such products are not equipment. Tangibility is the characteristic of that term, which they lack. Even if they are so deemed, they cannot be viewed as "industrial, commercial or scientific." Their use, therefore, cannot be said to be the use of the equipment which is industrial, commercial or scientific.

Computer equipment

Computer equipment could be viewed as industrial, commercial or scientific equipment and the payments for its use, royalties if:—

1. The customer
 - is in physical possession of the property;
 - controls the property;
 - has a significant economic or possessory interest in the property;
2. The provider does not
 - bear any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract;
 - use the property concurrently to provide significant services to entities unrelated to the service recipient ;
3. The total payment does not substantially exceed the rental value of the computer equipment for the contract period.

The above factors are non-exclusive. Some may not be relevant in particular cases.

Provision of services - Transfer of property

The basic distinction between a transaction in goods versus a transaction in services is whether the customer acquires property from the provider. Whether digital products can be termed property, there are conflicting views. According to one, they represent intellectual property of the owner which cannot be transferred in the manner in which other physical goods can. What is transferred is the right to use. According to the other, the term "property" should be understood to include property which typically is carried on a tangible medium but may be transferred from medium to medium such as electronic data, a software programme copy, digitised music or video images, and other forms of digital information and contents. The latter view is generally favoured by the OECD Members.

If a customer engages the vendor to create copy, say, a software programme that the customer will own from the moment of its creation, then no property will have been transferred from the vendor to the customer. The customer owns all the rights to the property as of the moments of its creation. The transaction is characterised as the provision for services. The transaction is also so characterised, despite the transfer of property from the vendor to the customer, if the predominant nature of the transaction is the provision of services. The transfer of ownership is merely ancillary.

Principles of taxation under the Income-tax Act, 1961

5.4 For determination of income or profit under the Income-tax Act, 1961, the basic principle is that a non-resident will be chargeable on the income that accrues or arises to him, or is received by him in India or that is deemed to so accrue, arise, be received. Two provisions in this regard need to be noticed, one relates to business and other assets, and, second, to royalty and technical fees.

Principal of taxation - Business income

5.4-1 Section 9(1)(i) of the Act brings into the Indian tax net all income of a non-resident which has some nexus in India giving rise to income such as a business connection, a property, an asset or source of income or a capital asset. Business connection is postulated where the non-resident carries some and not all operations that give rise to the accrual or arisal of profits in India. Supreme Court explains this fully in *CIT v. R.D. Aggarwal & Co.* [1965] [56 ITR 20](#). The earlier concept that profits of a business arise only at the place where sales take place, has given way

to conditions of modern business which add to the value of the goods or services ultimately supplied. The concept of distributive accrual has emerged, as established by the Supreme Court in *CIT v. Ahmedbhai Umarbhai & Co.* [1950] [18 ITR 472](#) and *Tata Iron & Steel Co. Ltd. v. State of Bihar* [1963] 48 ITR 123 and other cases. Section 9 of the Income-tax Act gives statutory recognition. Sub-clause (i) of clause (1) thereof read with *Explanation 1* thereto enacts that, where a non-resident earns income from a business the entirety of operations of which is not carried on India, he will be taxable in India not on the totality of the profits of the business as a whole but only on such part of the profits as is reasonably attributable to the operations carried out in India. This can be done in two ways. Profits attributable to the business operations in India can be separately ascertained and assessed, if possible. Alternatively, the entire profits are ascertained, and thereafter a proportion thereof as attributable to the said operations on some logical basis, such as turnover or relative importance of several operations. The profits so determined are computed under sections 28 to 44D of the Act and then brought to tax at the rate appropriate to such income or at special rate specified in the Act.

Principle of taxation - Royalty and technical fee

5.4-2 Section 9(1)(vi) and (vii) of the Act enacts a special rule in respect of the accrual of income in the nature or royalty or fees for technical services and deems such income to accrue or arise in India in the circumstances set out in clauses (a) to (c) thereof. Further, it is not enough that the income is fees for technical services for the purpose of the Act as defined therein. It is also necessary that it should be payable under an agreement with the Indian concern which either has the specific approval of the Government of India or which relates to the matter included in the Industrial policy for the time being in force of the Government of India and is in accordance with that policy—see *Section 115A* and *Ericsson Telephone Corporation India v. CIT* (AAR No. 269 of 1996) decided on the 20th June, 1996.

Principle of taxation under double taxation agreement

5.5 The DTA also proceeds on a like basis though the language used is somewhat different.

Principle of taxation - Business income under the double taxation agreement

5.5-1 The DTA provides that a non-resident will be taxable in India on business profits only if he carries on business through permanent establishment. Only such part of the profits is taxable as is attributable to that establishment. Its scope is, however, wider than scope of clause (a) of the *Explanation (1)* to section 9(1)(i) of the Indian Income-tax Act. It is just possible that the permanent establishment may be carrying on operations both in and outside India. In that event, profits attributable to the establishment will be not only the profits attributable to its operations in India but also outside. The Protocol which is a part of the DTA between India and France highlights the happening of such a situation, when it restricts the taxability of the business profits to that part thereof as is attributable only to the operations carried out by the permanent establishment in India. The net effect is practically the same as the application of section 9(1)(i) read with its *Explanation* of the Income-tax Act, 1961.

The distinction was pointed out by the Supreme Court in *DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) as :—

"Under article 7, the taxability is of the MNE what is to be taxed under article 7 is income of the MNE attributable to the PE in India. The income attributable to the said PE is the income attributable to the foreign company's operations in India, which in terms, implies the income attributable to the activities carried on by the MNE through its PE in India. Therefore, there is a difference between the taxability of the PE in respect of its income earned by it in India which is in accordance with the Income-tax Act, 1961 and which has nothing to do with the taxability of the MNE, which is also taxable in India under article 7, in respect of the profits attributable to its PE under article 7, the taxability is of the MNE. What is taxable under article 7 is profits earned by the MNE. Under the said Income-tax Act, the taxable unit is the foreign company though the quantum of income taxable is income attributable to the PE of the said foreign company in India."

Principle of taxation under double taxation agreement - Royalty and technical fee

5.5-2 The DTA also proceeds to lay down separate rules for the assessability of payments in the nature of royalties and technical fees. The definitions of those expressions are analogous, though not identical with, those contained in

the *Explanation* to section 9(1)(vi) and (vii). The definitions encompass payments as representing consideration for the use, or right to use, of the intellectual property rights and for various services. The definition was extended by the Finance Act, 2001, with effect from 1-4-2002, to the use or right to use any industrial, commercial or scientific equipment. In some Agreements, definition of the expression "fee and for technical services" is somewhat different from that contained in the Act. For example, in the case of Agreement with France, the statutory definition takes into consideration any kind of managerial, technical or consultancy services. It does not include "consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income chargeable under the heads 'salaries' ". The Agreement with France does not contain this limitation. The consequence is that while for the purpose of the said Agreement all payments will qualify as "fees for technical services", such payments made in consideration for construction, assembly or like project will not be treated as "fees for technical services" in the contexts where the Act comes up for consideration. There are at least two such contexts. One, in regard to the applicability of section 115A; and the other, section 44D of the Income-tax Act, 1961. Section 115A is a special provision for taxing income of non-residents. The rate of tax as provided therein for fee for technical service is on the gross amount. Fee received in consideration of construction, assembly, mining or like project does not qualify for such rate as it does not fall within the statutory meaning. In that case the amount is assessable as business profit. The second consequence is that if such amount is taxed as business profit under article 7 of the said agreement read with Indian Income-tax Act, section 44D of that Act will not apply as the consideration is not "fee for technical services" within the meaning of that section. In other words, in determining the assessable profit, the non-resident will be entitled to exclude the application of section 44D and claim deduction of expenses attributable to the earning of such income, if any. The two consequences are, (1), the rate of tax applicable will not be as provided under section 115A but will be the rate appropriate to the total income of the recipient; (2), the amount of taxable income of this description will not be the gross amount, but the net amount arrived at after deduction of the expenses incurred for earning such income (*see* AAR No. p-13 of 1995, In re, decided on 23rd August, 1995). Section 44D of the Income-tax Act is a special provision for computing income by way of royalties or technical fees. No deduction in respect of expenditure or allowance is allowed under any of sections 28 to 44C in computing the income by way of royalty or fees for technical services received from the Government or an Indian concern in pursuance of an agreement made after the 31st March, 1976. The consequence is that for computation of such income as business income in term of article 7 of the DTA negates the allowance of any deductions whatsoever from the gross payments. It would mean then that the entire gross amount of royalty or fee for technical services is taxable at the rate as applicable to the business profit. However, it is not so to be. The Act itself provides relief. This is under section 115A. It relates to rate of tax with respect to various categories of income of a foreign company.

Rate of tax - Special relief in respect of foreign companies under the Income-tax Act

5.6 As aforesaid, section 115A of the Act is a special provision relating to rates of tax with respect to various categories of income of a foreign company which is taxable in India. Section 115A(1) consists of two clauses. Clause (a) applies to foreign companies as well as other categories of non-resident taxpayers. It covers a case where such assessee derives income by way of dividends and interest on moneys lent in foreign currency to the Government or to the Indian concern or income from units of certain mutual funds purchased in foreign currency. Clause (b) deals with foreign companies whose income includes income by way of royalties and fees for technical services received from the Government or an Indian concern under an agreement entered into after 31st March, 1976. However, before section 115A could apply it should be ensured, as aforesaid, that the agreement with the Indian concern has been approved by the Central Government or relating to matter included in the Industrial policy of the Government of India for the time being in force.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - PREAMBLE

IntroductionIntroduction

6.1 Every tax agreement contains a preamble which normally reads as follows, so far as India is concerned.

Whereas the Government of the Republic of India and the Government of have concluded an Agreement as set out in the Annexure hereto, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income ;

And whereas all the requirements have been completed in India and as are necessary to give the said Agreement the force of law in India and respectively, as required by paragraph 1 of article 28 of the said Agreement.

And whereas the diplomatic notes to the effect have been exchanged between the said two Governments, as required by paragraph 2 of article 28 of the said Agreement.

Now, therefore, in exercise of the powers conferred by section 90 of the Income-tax Act, 1961 (43 of 1961) the Central Government hereby directs that all the provisions of the said Agreement shall be given effect to in the Union of India.

It sets out the object of the agreement. It states that after all necessary requirements having been completed it has the force of law in the Contracting States, and its provisions shall be given effect to in the Union of India on the Central Government of India having so directed by virtue of the power conferred upon it by section 90 of the Income-tax Act, 1961.

Preamble is a key to understand the agreementPreamble is a key to understand the agreement

6.2 A treaty is best understood if we know its reasons and objects. These reasons could be discovered from the preamble of the treaty. The preamble of a statute is a key to the understanding of it and may be legitimately consulted to resolve the ambiguity. It is done only when the enacting part is open to doubt—*Kavalappara Kattaranthil Kochuni v. State of Madras* [1960] 3 SCR 887. The same principle is applicable in understanding the agreement.

The preamble reveals the intention of the parties and purpose. With a view to implementing that intention, the treaty must be given a liberal interpretation. "A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated in so far as the particular item is concerned" (*see John N. Gladden v. The Queen* 85 DTC 5188). The preamble normally provides that the agreement between the two Governments for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes is entered into. The purpose as revealed in the preamble is the avoidance of double taxation and prevention of fiscal evasion. Such being the intention, the agreement is read liberally to implement it. The expression "avoidance of double taxation" on the face of it would arise only when tax is actually paid in one of the contracting States. The Supreme Court of India did not agree, in *Union of India v. Azadi Bachao Andolan* [2003] 263 ITR 706 (SC). The Supreme Court observed that merely because, at a given time, there may be an exemption from income-tax in respect of any particular head of income, it is not correct to say that the taxable entity is not liable to taxation. Liability to taxation is not the same as payment of tax. Liability to tax is a legal situation : payment of tax is a fiscal fact.

Tax treaty - Role

6.3 Tax is a barrier to trade and inhibits its growth. International tax basically is a part of the trade which encompasses trade in goods and services, and capital and financial markets. Tax treaties play the following roles :

1. Eliminating double taxation, thus creating a more favourable investment climate in the country;
2. Facilitating inward investment flows. These include preventing discrimination between the tax payers ;
3. Adding fiscal certainty to cross border operation.

Broadly, the general objectives of bilateral tax agreements may be seen to include the full protection of taxpayers against double taxation and the prevention or discouragement which taxation may provide for the free flow of international trade and investment and transfer of technology. They also aim to prevent discrimination between the tax payers in the international field, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations are carried out. The agreements have as an objective of co-operation between tax authorities in carrying out their duties. Such agreement is an attempt to invoke the concept

of the comity of nations or of rules of international law in interpretation of an agreement that derives legal sanctity from a country's own Income-tax Act. In India, section 90 is such a provision.

Tax treaty - Objectives

6.4 The tax agreement seeks to achieve two basic objectives :—

1. To eliminate tax barriers to international trade and investment;
2. To combat international tax avoidance and evasion.
3. To promote mutual economic relations, trade and investment.

In furtherance of these goals, the tax agreement seeks to mediate between competing jurisdictional bases for income taxation (typically between source and residence states), to develop common frameworks for certain basic concepts necessary to the application of the tax agreements, such as determination of residence and entitlement to benefits; and to establish mechanism for resolving inter-Governmental disputes as well as alleviate any remaining instances of potential double taxation of tax payers covered by the tax agreements. Cross border investment would be seriously impeded if there were a danger that the returns are taxed twice, both where money was invested and where the investor is resident. The tax treaty avoids this happening by providing clear basic rules for taxing income and capital. Double taxation is avoided with respect to investment income by allocating taxing rights between the residence and the source countries. Matters which are covered in a tax treaty relate to—

1. Imposing liability to tax in one country whilst granting exemption in the other;
2. Deeming geographical source provisions for particular categories of income to be in one country than in the other;
3. Imposing liabilities to tax in the country in which the income is deemed to arise.

Prevention of fiscal evasion

6.5 All the countries are concerned about the erosion of their revenues caused by arrangements or transactions which enable dual resident companies to obtain a double tax deduction for the same losses and, therefore, have taken and/or are taking action to quash tax avoidance practice known as 'double dipping'. The courts in these countries, of late, have been frowning upon the arrangements or transactions involving double dipping between a resident company and another in the other country, because of the contrived nature of such arrangements, which are motivated wholly or largely by perceived tax advantage. Tax authorities world over are aware of such transactions, especially in the field of offshore funding and the use of the companies and trusts in the so-called tax haven countries. Many of these schemes are loops disguised in various forms. Some arrangements are blatant tax evasion. Transactions are documented in a way as to inflate/deflate artificially the sale/purchase price to twist the profits of an enterprise solely with a view to deriving tax advantage. Tax motivated loop transactions are undertaken under the belief that the tax authorities in one country cannot have access to records or evidence in another without which the true nature of the transactions cannot be unravelled. Non-disclosure or the non-availability of the information to the taxing authorities have encouraged the tax avoiders to adopting of suitable camouflage techniques such as back-to-back loan, share sales, under or over-invoicing.

For the prevention of tax evasion, the tax agreements made provisions for exchange of information as also enabling the tax authorities of the other country to have access to the information and records which could not have been otherwise available to them. With the help of such information and records the Contracting States are able to prevent international tax evasion.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - PERSONAL SCOPE

ARTICLE 1 PERSONAL SCOPE

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

IntroductionIntroduction

7.1 States levy taxes on the basis of their own tax laws. The tax treaties rules also so assume. Their purpose is to avoid double taxation of an income. For doing so it is necessary to limit the domestic tax laws in the cross-border cases either by excluding application of the domestic tax laws of one of the states or requiring the states to allow a credit against their own tax for taxes paid in other states. Thus three questions arise:—

1. Is the treaty binding on the taxing state.
2. Whether a particular taxpayer is entitled to treaty benefits.
3. Does the treaty apply to the tax in question.

As for 1 above, the matter has already been discussed. The second question can be answered by reference to the provisions of article 1 of the OECD/UN Model which provides that the Convention applies to persons who are residents of one or both the Contracting States. For the third question article 2 has to be referred which describes the covered taxes.

"Person" is treaty subjectPerson is treaty subject

7.2 The concept of "person" is at the heart of the treaty provision, as in the case of all tax laws. The determination of tax liability involves determining who person, in respect of what property or income, is liable and then determining the tax which he is liable to pay. The liability to pay tax arises on a person whose income is subject to charge to tax under the domestic laws of the contracting States. The concepts of liable "person", "income" and the "tax" are therefore, all very relevant for a tax treaty. The person is in focus of the treaty, whether as recipient of income, the owner of property, the object of the procedural provision or beneficiary of the treaty entitlement.

The treaty affects all resident persons of the contracting states, who have business dealings with other contracting state or who have income from specified sources as interest, dividends, royalty etc. from the state other than of their residence or who receive payments from such state. Its scope, therefore, relates to matters as to who particular taxpayer is entitled to treaty benefits. The concept of "person" is of great importance, whether as an owner of the property or investment or business and the source of income being such investment or business or his personal skill. He is entitled to the benefits if he is recipient of the income in law or in fact and additionally a resident of one or both of the contracting states. The treaty object is the person. What is to be determined first, whether an entity is a person, second, whether it is resident and, third, whether it is recipient of income. The two expressions "person" and "residence" are separately dealt with and defined in every tax agreement. Article 3 defines person; article 4 determines residence. On such determination depends the relief on the terms of the agreement. This is what article 1 says. The benefit is confined to only those who come within these definitions.

Under Article 4 a person is generally treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile or other similar criteria. If, however, a person is considered resident of the other Contracting States, a single state of residence is assigned under Article 4. This definition governs for all purpose of the treaty. Where a provision applies or not to such person, there is a specific mention. For example, Article 19 (Government service) applies to an individual to whom salaries etc. are paid ; paragraph 1 of Article 24 (Non-discrimination), to nationals ; paragraph 26 (Exchange of Information), with respect to residents of third states, article 7 applies to an enterprise and not to person.

Person - Relation between the StatePerson - Relation between the State

7.3 Tax treaties establish a mechanism to avoid double taxation through the division of the tax claims of the contracting states. They divide the tax sources or the tax objects. It is, therefore, necessary to designate the particular objects to which the agreement applies for distribution of income amongst the states. Income may arise from activity such as business or professional activity, or a property tangible or intangible. Computation of income with reference to activity or the property has to be decided and thereafter the right of each contracting state to tax it. The relation between the tax object and the person receiving it on the one hand and the state on the other has to

be established either by the presence of the activity in the state such as a fixed place or permanent establishment, or of the situs of the real property, or by residential status of the person receiving it. Income attributable to the presence of the activity or the property in the state is taxable in that state. Distribution of income is thus mainly dependent upon the principle of attribution.

Person - Tax treaty benefit if liable under the domestic law

7.4 Tax claim of each contracting state is limited to the amount as arrived at on the basis of attribution. A question may arise whether the treaty provision would still be applicable if an enterprise is liable to tax only in one of the contracting states, as for example, when it is liable to tax in its own capacity in the country of source but not so liable in the country of residence. The benefit cannot be denied to it only on the ground that it is not liable in the country of his residence which may be because of his having no income or property there or the income being exempt from tax though he may be "resident" there. A person if not so deemed to be in terms of the domestic law though he qualifies for that status according to an agreement does not forfeit the claim of agreement protection. To define "residence" in article 4 with reference to the criteria as laid down under the domestic law is only to establish a physical connection and not to deny the benefit of the agreement provisions. Paragraph 1 of article 4 contemplates that the liability to taxation for the purpose of the agreement should arise out of some nexus between a state and the person. The four expressions "resident", "domicile", "place of incorporation", and "place of management" have been used only to indicate the need for the existence of some nexus between the person and the state concerned which can justify imposition, by that state, of the tax on income sought to be taxed. In India a person is taxed under the Income-tax Act, 1961, on the income that accrues or arises or is deemed to accrue or arise to him in India and the income that is received or deemed to be received by him in India. The nexus for the taxability is the locus of the income which in international law, can justify the taxation even though the person may be non-resident. Territorial nexus for the purpose of determining the tax liability is an internationally accepted principle—see *Ishikawajima-Harima Heavy Industries Ltd. v. DIT* [2007] [158 Taxman 259](#) (SC)]. A State can assert jurisdiction to tax income arising to a person who is its resident, though presently may not have been done. Non-exercise of jurisdiction does not mean that it is not exercisable and the person resident because of his territorial connection with the State not liable to tax. This is sufficient to make a person resident in India within the meaning of paragraph 1 of article 4. A non-resident becomes resident in India within that meaning entitling him to claim benefit of tax treaty - *Mohsinally Alimohammed Rafik, In re* (AAR No. 206 of 1994 decided on the 23rd December, 1994). Reference to the person who, under the laws of a state, is liable to tax therein by reason of his domicile, residence, place of incorporation or place of management or any other criterion of a similar nature connotes not the existence of an actual taxation measure in the state under which the person in question is factually charged to tax but will connote a person who is liable to be subjected to tax by the taxation laws of that state by reason of the said any nexus between him and the state. Such a person is entitled to benefit of the tax treaty.

Similarly, if an entity which qualifies to be a person within the meaning of article 3 is not taxable as such, it should not be treated differently. Non-taxability in the state of residence of a person and entity (not being taken as a person under the domestic law) are not the relevant considerations for denial of treaty benefits. A person should be treated resident if his physical connection with the contracting state so qualifies him, had he been liable in the status of a resident. Consequently, in the source state, which treats it as an independent taxable entity, the person is entitled to agreement protection.

Person - Extent of benefit is not decided by article 1

7.5 Article 1 does not decide the extent of benefit. It depends on the other terms of the agreement. What has to be seen for the purpose of the article is that the person is resident in either of the Contracting States, in terms of article 4. Article 1 deals with two specific issues about the agreement; (1) its abuse (treaty shopping), and (2) its application to partnerships and trusts. These are discussed in the following paragraphs.

Person - Improper use of the treaty

7.6 One of the purposes of the double taxation treaty is to prevent tax avoidance and evasion. Evasion is breaking the law and avoidance taking advantage of it to minimize one's tax liability. In determining tax liability, the form is ignored over substance if the transaction is intended avoidance. It is akin to the doctrine of the abuse of right in civil law which prevents people from taking advantage of statutory rights that appear to exist on a literal interpretation of legislation, contrary to the broad spirit of the law. The doctrine of substance over form in tax laws

operates to look through the form of the transaction if the taxpayer's dominant intention is to avoid paying or deferring taxes.

Improper use of treaty - Transfer of residence

Abuse or improper use of treaty provision is taking unintended advantage. For example, a person acting through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly, or a person transferring his permanent home to the Contracting State to take advantage of little or no capital gain tax regime of that State to avoid tax on sale of shares (*see* OECD Commentary, article 1, paragraph 9).

There may be various considerations other than tax for a person to transfer of his residence. Whenever he does, he is subject to international double taxation if he maintains a source of income in the country of his original residence. If there is a double taxation agreement between the two countries, the question of jurisdiction to tax income would arise. The source State does not give up its right to tax dividend, interest, salary, Government remuneration and pensions. The person may claim relief from the residence State.

Sometimes, transfer of residence especially in a low or no tax State is tax motivated in order to achieve tax exemption on the capital gains. A person owning a substantial shareholding or securities may shift his residence in order to avoid paying tax on capital gains on the transfer of such shares or securities, if the double taxation agreement between the two countries allocates the right to tax to the residence State [OECD Model Convention article 13(5)]. Full exemption could also be availed on realization of shares if the new residence country does not levy capital gains tax on shares and securities or on substantial shareholdings in the companies that are not resident there. Transfer of residence if tax motivated, is an abuse of treaty. The use of such a device as transfer of residence may be characterized as "the use of artificial legal construction aimed at securing the benefits of both the tax advantages available under certain domestic laws and the relief from tax provided for the double taxation provision" (*see* OECD Commentary, article 1, paragraph 8) and would be an abuse of the Convention. However, *bona fide* emigration is different from artificial legal construction. To counter, a State may under its domestic laws may treat transfer of residence as a taxable event and deem shares or securities as having been transferred giving rise to capital gains tax.

Improper use of treaty - Guiding principles

To determine whether a transaction is abusive, the guiding principle is that the benefit of the treaty should not be available where the main purpose of entering into certain transactions or arrangements was to secure more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions (*see* OECD Commentary, article 1, paragraph 9.5). Some forms of tax avoidance have been expressly dealt with in the Model Convention, *e.g.*, by introduction of the concept of "beneficial owner" (in articles 10, 11 and 12) and of special provisions such as paragraph 2 of article 17 dealing with so-called artiste companies (*see* OECD Commentary, article 1, paragraph 10).

The OECD Commentary on article 1 deal with improper use of treaty under the following heads :

- Provisions relating to conduit company cases;
- Provisions which are aimed at entities benefiting from preferential tax regimes;
- Provisions which are aimed at particular types of income;
- Anti-abuse rules dealing with source taxation of specific types of income;
- Provisions which are aimed at preferential regimes introduced after the signature of the convention;
- Provisions dealing with other forms of abuse (*e.g.*, the use of base company), such as—
 - "substance over-form", "economic substance";
 - general anti-abuse rules;
 - Controlled foreign companies provisions.

Conduit company cases

The OECD Commentary on article 1 also refers to some measures to prevent improper use, such as refusal of claims to treaty benefits by subsidiary companies established in tax havens (paragraph 10.1) (discussed later), disallowing treaty benefits to a conduit company not owned, directly or indirectly, by the residents of the State of which the company is resident. A report of the Committee on Fiscal Affairs called "Double Taxation Conventions and the Use of Conduit Companies" examined provisions which could be used to safeguard against conduit

companies. The matter relating to improper use of the treaty is examined through the "look through" approach, "subject-to-tax" approach, "channel" approach, "exclusion" approach.

1. *Look through approach* - Treaty benefit may be denied to a company not owned, directly or indirectly, by residents of the State of which the company is resident (*see* OECD Commentary, article 1, paragraph 13). This approach seems an adequate basis in relation to countries which levy no or very low taxation and where little substantive business activities would normally be carried on, although subject to an exception for *bona fide* business activities (*see* OECD Commentary, paragraph 14)
2. *Subject-to-tax approach* - Treaty benefits in the State of source are granted if the income in question is subject to tax in the State of residence (OECD Commentary, paragraph 15). The Commentary says that whilst this seems adequate with respect to normal international relationship, this approach might well be adopted in a typical conduit situation. The safeguarding provision of this kind should require that one or more residents of the third country have substantial interest in such company in the form of participation or otherwise or exercise the management or control of such company. The emphasis is on "substantial interest" by non-residents in person claiming treaty benefits. *Bona fide* activities are, however, excluded.
3. *Channel approach* - The approach deals with conduit problem in a more straight forward way by singling out cases of improper use with reference to conduit arrangements themselves. Treaty benefit could be denied if substantial interest in the company is owned by residents of the third country and more than 50 per cent of the income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes) (*see* OECD Commentary, paragraph 17)
4. *Exclusion approach* - The approach includes denying treaty benefits (such as dividends, interest, capital gains or director's fees) to specific types of companies enjoying tax privileges in their State of residence (*see* OECD Commentary, paragraph 21)

The above provisions do not apply in *bona fide* cases, *i.e.*, if it could be shown that company is motivated by sound business considerations and does not have as a primary purpose the obtaining of any benefits under a treaty, or the company is engaged in substantive business operations in the Contracting State, or amount of tax relief is not greater than to the tax imposed 'by the Contracting State, or if the principal class of its shares is registered on an approved stock exchange in a Contracting State, or if there is alternative relief provision in treaties concluded by non-residents' State (*see* OECD Commentary, paragraph 19)

Each of these different approaches deals with a particular aspects of the problem commonly referred to as "treaty shopping" (*see* OECD Commentary, article 1, paragraph 20). That paragraph further says "States wishing to address the issue in a comprehensive way may want to consider a limitation-of-benefits (LOB) provision aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States, keeping in mind that adaptations may be necessary and that many States prefer other approaches to deal with treaty shopping." Only qualified person is entitled to treaty benefit and the qualified person is an individual, a governmental entity, a company whose shares are listed and regularly traded in recognized stock exchange or five or fewer of such companies own directly or indirectly at least 50 per cent of its shares, a charity or other tax exempt entity, pension trust if more than 50 per cent of beneficiaries, members or participants are residents in either of Contracting States, person other than an individual if the above qualified persons own directly or indirectly 50 per cent of shares or other beneficial interests for at least half the days of the fiscal years or if less than 50 per cent of the income is paid or accrued directly or indirectly to persons who are not residents of either of the Contracting States in the form of payments that are deductible for purposes of the taxes covered by the treaty in the person's State of residence (*see* OECD Commentary, article 1, paragraph 20). That paragraph further provides that treaty benefits could not be denied if the resident is actively carrying on business irrespective of whether he is a qualified person or if the competent authority determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of the benefits under the treaty (LOB provision is further discussed later).

Treaty shopping

The scope of a tax treaty determines the person who is entitled to its benefits, *i.e.*, the "person" who is "resident". It has first to be established whether an individual or an entity is a person, and, then, whether that person is liable to

tax in a contracting state by reason of his domicile, residence, place of management or any other criterion of similar nature. A resident of the third state is not entitled if he claims through the device what is known as "treaty shopping". Taking advantage of a double taxation agreement between the two countries by a resident of the third country is known as treaty shopping.

Treaty shopping is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between States. A person acts through a legal entity created in a state essentially to obtain treaty benefits that would not be available directly to such person. That entity may be abused by such persons (residents of third country) to obtain in the source state treaty benefits which they themselves would not be entitled in case of direct investment. On the other hand the entity may be abused to distract the investment's proceeds from the state of residence of a participant. Treaty shopping results in tax avoidance because treaty benefits are obtained by unintended beneficiaries who do not reside in treaty country, but channel their investments through entities formed in such a country. "Treaty shopping" is thus the use, by the residents of third states, of legal entities established in a Contracting State with a principle purpose to obtain the benefits of a tax treaty.

The device involves routing of income arising in one country to a person in another through a third country. The following illustration explains the concept :—

1. X is a resident of a country A
2. X receives interest from country B which is subject to tax in B (15 per cent)
3. A does not have tax treaty with B
4. A has a tax treaty with another country C (withholding tax 5 per cent)
5. B has also a tax treaty with C (withholding tax 5 per cent)

Thus C is a country with which A & B has a separate treaties, though between A & B there is none. This situation is taken advantage by X by arranging his affairs in such a manner as to interpose a third country C in order to reduce the tax effect which otherwise would have been 15 per cent. This he could by introducing a person Y who is resident of C, who receives interest from B and then makes to appear arising to X in C and passes to him country A by this arrangement income is made to suffer withholding tax as follows:—

- a. 5 per cent when Y receives it (agreement between B and C)
- b. 5 per cent when X receives it from Y (agreement between C and A)

The total of *a* and *b* above works out to 10 per cent. It would have been otherwise 15 per cent. In this situation country B suffers a tax loss. It only got 5 per cent whereas it was entitled to 15 per cent.

In another situation A, B and C have tax treaties with each other with varied withholding tax rates; (15 per cent) (A and B), and 5 per cent (B and C). In order to save tax X instead of making investment in B directly, does it through C by establishing a company therein which makes it. The tax saved is 10 per cent. This situation corresponds to the facts of X limited case (discussed below).

Treaty shopping - Objective and feature Treaty shopping - Objective and feature

7.6-1 The device of treaty shopping is used to obtain the tax advantage. It is achieved because the third country has the treaty with the first which the said another country does not have or because the route is more efficient than the direct route even though there is an appropriate tax treaty on that route also. It is resorted to achieve the following objectives :-

1. Royalties, interest or dividends should suffer reduced or no withholding tax (as in the X-limited case discussed below);
2. Wide range of treaty benefits are obtained by an MNC by locating itself in a jurisdiction which has wide treaty network;
3. Access to international markets for borrowing is obtained by establishing a subsidiary company in a country which does not apply withholding taxes on interest payments to non-residents. Borrowings are made through such subsidiary. This is done by establishing a company or other appropriate entity in another country whose own laws make it suitable base for the international investment and which has the most favourable double taxation treaty available with the other country into which ultimate investment is to be made so that access can be had to the network of double taxation agreements of that country. The countries most commonly used as a base for international investments are the Netherlands and Switzerland which have network of favourable tax

treaties. The Netherlands is very popular location for international holding company, finance company and royalty company. Switzerland is similarly favourable for holding company and sale company. The countries which offer "offshore" sanctuary besides Switzerland, are Luxembourg, the Bahamas, the Netherlands Antilles, Panama, Liechtenstein, Antigua, Cyprus, the British Virgin Islands, the Isle of Jersey, the Caymans etc.

The basic feature of "treaty shopping" is the establishment of base companies in other states solely for the purpose of enjoying the benefit of a particular treaty rules existing between the state involved and the third state. Legal consequences are not really intended or intended only because of the tax consequences.

In *Aikem Industries Inc. v. Commissioner* (1971) 56 TC 925 which dealt with abusive treaty shopping, a Bahamian corporation receiving interest from a US president established a Honduran conduit corporation to collect the US sourced interest, claim treaty exemption from withholding tax under the US-Honduran income-tax treaty then in effect, and remit the collected interest of the Bahamian company. The Tax Court held that the Honduran corporation did not qualify for treaty benefits because it was a mere collection agent and did not receive the interest of its own. The court ruled the transaction was void of any "economic or business purpose". Under such circumstances as the absence of any economic or business purpose, exist, or the treaty itself contains a prohibitive provision, the doctrine of treaty shopping may not be applied. The matter is discussed in detail by the Supreme Court of India in the case of *Union of India v. Azadi Bachao Andolan* (discussed later).

Treaty shopping - International tax planning

7.6-2 The purpose of a tax treaty is only to be bilateral and to benefit the *bona fide* residents of the contracting states and not those of the third. The international tax planning like the domestic tax planning practised with a view to avoidance of tax is opposed by the Contracting States like under the domestic laws. Under the domestic laws transactions are disregarded which are undertaken not for any commercial purpose but done for tax purposes alone, by employing unusual or artificial measures, to circumvent the words of the statute, which would not have been employed aside from tax considerations. The doctrine of substance and form is applied. It is discussed in detail later. The courts have been applying anti-avoidance principles formulated for the domestic laws to double taxation agreements—*Aiken Industries Inc. v. Commissioner* [1971] 56 TC 925, *Johansson v. United States* 336F 2d 809 and *X Limited, In re* [1996] [86 Taxman 252](#) (AAR). It has, therefore, to be seen whether the base company is established in the other states solely for the purpose of enjoying the benefit of the particular treaty rules between the involved and the third state. The advantage would not have been otherwise available but for setting up of a legal structure in the involved country. Such a doctrine has to be applied with care and caution. Under the pretext of preventing treaty shopping, absence of business purpose may not be presumed in every case, unless the tax avoidance is involved. Thus, where a foreign subsidiary is engaged actively in the state of its location, though the avoidance of tax is the motive for its establishment, the third country tax treaties cannot be said to be abused. Tax avoidance alone cannot be the basis for such application unless it is resorted to through a company or entity or a transaction which is either shown or lacking business purpose. Tax planning on the domestic and the international tax level is by no means objectionable. Extensive tax planning indicates defect in the legislation. Beyond a point, it cannot be tolerated within a legal system if it is intended that the system is just. Such a limit is reached if enjoying a benefit under a treaty is the only purpose in establishing a base company in another country - *Aikem Industries Inc. v. Commissioner* [1971] 56 TC 925 and *Johansson v. United States* 336 F 2D 809.

The agreement between India and Mauritius has very recently caught the imagination of treaty shoppers who make use of Mauritius as a base country for making investment in India. It is because the Mauritius taxation laws contain various advantages. The Netherlands is a country which has assumed a significant importance in international tax planning. Its tax regime has a number of specially advantageous features with regard to income from investment (*i.e.*, dividends, interest, and royalties and capital gains). The withholding tax on royalties and interest is *nil*, and on dividend 25 per cent which is reduced to normally 15 per cent (portfolio dividends) and 10, 5, or zero per cent (participation dividend, which is subject to minimum holding, generally 25 per cent, but 10 per cent in recent treaties). It has generally favourable and extensive net work of tax treaties. As regards the extent, it is only second to United Kingdom. Because there is no withholding tax on payment of interest, it is an attractive location to base a group of finance companies. For leasing companies, it is also very attractive. It grants generous tax allowances for writing off intellectual property rights. Because of the flexibility of its tax system and an extensive network of tax treaties, the Netherlands remains a very attractive regime for structuring investment.

Treaty shopping - X Limited case

7.6-3 An illustration of treaty shopping is found in the recent decision of the Authority for Advance Ruling New Delhi in *X Ltd., In re* [1996] [86 Taxman 252](#) (AAR). Two companies made applications to the Authority for Advance Rulings (AAR), New Delhi, seeking for its ruling on a question of payability of tax on dividends and on capital gains arising from the investments made in India in the light of the provisions contained in the tax treaty between Mauritius and India. The said companies though incorporated in Mauritius were fully owned subsidiaries of a banking company in Britain (British Bank). The business of these was investing in banking and the financial sector in India and each company has invested US \$ 60,00,000 by way of subscription for shares in an Indian Bank. The question referred to the AAR was whether the dividends to be received by those companies from the Indian Bank would be entitled to the benefit of concessional rate of taxation on account of their holding being 10 per cent of the capital of the Indian company *viz.*, the Indian Bank. The Double Taxation Agreement between India and Mauritius provides that the tax charged is not to exceed 5 per cent of the gross amount of dividends in case the recipient beneficial owner is a company holding at least 10 per cent of the capital of the dividends paying company. In other cases it is 15 per cent. The other question was whether capital gains arising from the alienation of the said shares would be taxable in Mauritius according to its laws and not in India, in terms of article 13(4) of the said Agreement.

While examining the said questions, the AAR considered a fundamental issue whether the applications seeking advance rulings are maintainable, on the ground that the raised questions relate to a transaction which is designed, *prima facie*, for the avoidance of tax. The question became relevant on the revelation that each of the applicants had only one shareholder, namely, the British Bank, a company resident in the United Kingdom. Had the British Bank directly invested in shares in Indian Bank, it would have been entitled to the relief provided by the Tax Agreement of 1993 between India and United Kingdom.

According to that Agreement the capital gains are taxable in India and dividends at the rate of 15 per cent. According to the one between India and Mauritius, a resident of Mauritius has to pay no tax with respect to capital gains, and 5 per cent with respect to dividends. It was claimed before the AAR that the shares in the Indian Bank were held by the said applicant companies of Mauritius beneficially and that, therefore, dividends from shares should be charged to income-tax at 5 per cent and the capital gains on sale of such shares be not charged at all. The AAR found that the purpose of investment in shares of the Indian Bank is the avoidance of taxes which would have fallen on the British Bank had it directly invested. It, therefore, rejected the applications.

Azadi Bachao Andolan case

7.6-3A The Supreme Court in *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) (SC) examined in detail the doctrine of treaty shopping. The Government of India has entered into an Agreement with the Government of Mauritius for the avoidance of double taxation and for the prevention of fiscal evasion. It is applicable to persons who are residents of one of both the contracting States, *viz.*, India or Mauritius. The expression "resident" has been defined in Article 4. The Central Board of Direct Taxes, in its circular No. 789 dated the 13th April, 2000, clarified that wherever a certificate of residence is issued by the Mauritius Authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the Agreement accordingly and also for the purpose of capital gains on sale of shares, and that the Foreign Institutional Investors (FIIs) which are resident in Mauritius would not be taxable in India on income from capital gains. The FIIs are the offshore companies registered in Mauritius for not doing business in Mauritius. According to the Delhi High Court [*Shiva Kant Jha v. Union of India* (2002) [122 Taxman 952](#)] the Income-tax Officer is entitled to lift the corporate veil in order to *see* whether a company is actually a resident of Mauritius or not and to refuse the benefit of the Agreement if found not to be so, on the basis the doctrine of "treaty shopping". The Court also held that treaty shopping is illegal. The Supreme Court did not agree and observed, *inter alia*, as follows:

- (1) There are no disabling or disentitling conditions under the convention prohibiting the resident of the third nation from deriving benefits thereunder, such as one contained in Article 24 of the Indo-US Convention.
- (2) The motives with which the residents of a third country have been incorporated in Mauritius are wholly irrelevant and cannot in any way affect the legality of the transaction.
- (3) The principle of piercing the veil of incorporation cannot apply.

Absence of article in the Indo-Mauritius treaty similar to Article 24 of the Indo-US treaty limiting the benefit of the treaty to third party residents in the circumstances mentioned therein, appears to have persuaded the Supreme

Court into holding that the residents of the third country could avail of the benefit of Indo-Mauritius treaty if they are residents of Mauritius in terms of that treaty.

The Supreme Court was perhaps not apprised of the background of Article 24 which is referred to as limitation-on-benefit (LOB) (discussed below). It is based on Controlled Foreign Corporation (CFC) Rule enacted by US to restrict the beneficial use of favourable tax regimes by US multinational corporations. The US adopted its CFC rules in 1962 to restrict the use of foreign corporations controlled by residents to defer domestic corporations on foreign source income, including tax haven income (the matter relating to CFC rule is discussed later). The principle of LOB is to avoid double taxation and not to allow treaty shopping. It is designed to ensure that it is relevant where there is taxation of the investor (*e.g.*, as dividend or interest). It has no relevance to business income, which is taxed on the basis of permanent establishment. Article 24 of the Indo-US treaty attempts to look through the corporation to ascertain whether more than 50 per cent of shares is owned, directly or indirectly, by one or more individual residents of the Contracting States and so on. That article has fixed the standard for LOB, on the principle of looking beyond the corporate facade, which principle the Delhi High Court upheld but rejected by the Supreme Court. In the absence of article similar to article 24 in other treaties, it could be taken that the Contracting States may not desire to lay any standard but nonetheless desire that the benefit be restricted only to their *bona fide* residents in terms of article 1 and for that purpose authority may look through the corporation. There are many countries, including India, which have no CFC Rules. Their treaties with each other obviously do not have a clause similar to the said article 24. On the parity of reasoning of the Supreme Court, the benefit of those treaties could be extended beyond the *bona fide* residents to the residents of the third country. This, perhaps, cannot be the intention of the treaties.

Explaining the provision of LOB (*e.g.*, article 24 of the Indo-US treaty), the Technical Explanation of the US Model Convention states that it (LOB provision) sets forth a series of objective tests rather than subjective determination of the intent of the taxpayer's attempt at treaty shopping which the administration is normally ill equipped to identify and that the assumption underlying each of these tests is that the taxpayer that satisfies the requirement of any of these tests probably has a real business for the structure it has adopted, or has a sufficient strong nexus to the other Contracting State (*e.g.*, a resident individual) to warrant benefits even in the absence of a business connection, and, that this business purpose or connection outweighs any purpose to obtain any benefits of the treaty (*see* clause 283 of the Technical Explanation). Clause 286 further provides:

"Article 22 (US treaty Model convention dealing with LOB) and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting States to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source State may be applied to identify the beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that principle is entitled to the benefits of the convention with respect to such income."

It could thus be seen that in order to prevent treaty abuse it is not necessary an LOB provision similar to Article 24 of the Indo-US treaty should exist in a treaty, if on interpretation of the treaty provisions treaty benefits could be denied on the doctrine of "treaty shopping" or otherwise done on the basis of domestic law anti-abuse provisions or law. It is because—

- LOB provision complements the domestic law and does not supplement or override it;
- domestic anti-abuse provisions (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance;
- domestic law principles of the source State may be applied first to identify the beneficial owner of an item of income and then the LOB provision;
- LOB sets forth a series of objective tests rather than the subjective determination of "treaty shopping".

In the case of *Azadi Bachao Andolan*, Delhi High Court appeared right to apply the domestic law principles of business purpose test or substance-over-form test as laid down in *McDowell* case to strike at the "treaty shopping". There appeared to be no need to look for the objective tests as in the LOB provision of Article 24 of the Indo-US treaty. The absence of objective tests specifically provided does not suggest that subjective determination could not be made, even if it is objectively done.

Further, Article 1 of the Indo-Mauritius treaty says that it shall apply to persons who are residents of one or both of the Contracting States. That article sets out the limitation of treaty benefits. In the Indo-US treaty, there is another limitation on the benefits, as provided in article 24 which says "A person (other than an individual) which is a resident of a Contracting State derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:" and then specifies the conditions. There are two limitations ; one that the person be resident of one or both the contracting states and the other as set out in article 24. The first is further qualified by the second. *Minus* such qualification, the first operates on its own terms. It perhaps cannot be interpreted in the light of some qualificatory requirement as provided in some other treaty. A treaty has to be interpreted on its own terms and not what some other treaties say and contain. The Supreme Court itself has agreed with the proposition that "expression 'resident' is employed in the DTAC as a term of limitation". That limitation is not further qualified by another limitation as is done in article 24 in the case of Indo-US treaty.

The question whether a person is resident of one or the other Contracting State has to be examined on the terms of the relevant treaty and is a question of fact and not on the terms of some another treaty. If a person is not resident in fact but makes himself so appear and grabs the benefit which is not intended for him, the authority would perhaps be justified to ascertain whether the said person is a person contemplated in the treaty before he proceeds to apply the treaty.

The decision of the Supreme Court is, however, a landmark as regards interpretation of tax treaties;

- A holistic view of treaty shopping has to be taken what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy;
- Many countries tolerate or encourage treaty shopping, even if it is unintended, improper, or unjustified, for other non-tax reasons.
- In developing countries, treaty shopping is regarded as tax incentive to attract scarce foreign capital and technology.

These new aids, besides purposive interpretation, set in the said decision of the Supreme Court for interpreting tax treaties, viz., holistic interpretation, "ends justifying means" interpretation, interpreting tax treaties on grounds of non-tax considerations, are deviation from the conventional approach.

Treaty shopping - Consequence to source country

7.6-4 The operation of treaty shopping affects the source country in the following manner :-

1. Loss of revenue by restricting the rate of its withholding tax;
2. Diminishing its negotiating power with respect to its own residents. The tool of its high rate of withholding tax could easily be blunted through treaty shopping;
3. Assisting tax evasion, which a treaty intends preventing.

Treaty shopping - Prevention - Recent trends

7.6-5 To arrange its affairs so that there is little tax effect, is within the domain of a person, when the law permits such arrangement. It is perfectly legitimate for the residents of one country to set up companies in other countries and benefit themselves of the advantage under the double taxation agreement as is available to the residents of the contracting states, though the benefits are intended to be granted to the residents of those states alone. The recent trends make departure. The new approach contends that the purpose of a tax treaty is only to be bilateral and, therefore, to benefit the *bona fide* residents of the contracting states, and not those of the third country. The countries are now enacting laws or abrogating or modifying the existing tax treaties so that the benefits are restricted to the actual residents of the treaty states. The third country residents would not be entitled.

By far the most active in this respect is the United States which has a clear policy against such third country use. Article 16 of the US Model Convention contains a provision denying treaty protection to a foreign controlled companies under certain conditions. It basically provides that all of the other benefits of the treaty shall be denied to companies or the other entitles resident in the other country unless they are publicly quoted or owned more than 75 per cent by individual residents of that country, except in cases where it can be shown that the establishment of the company or entity is not for the purposes of taking advantage of the treaty. A decision of the Swiss Federal Council of 1962 denies the benefits of tax treaties concluded by Switzerland to corporations residing in Switzerland if they distribute more than 50 per cent of their profits to persons not entitled to treaty protection and distribute less than 25 per cent. These provisions are later inserted into tax treaties concluded by Switzerland with

France and Germany. To combat the abuse of the treaty shopping, the UK has introduced a number of provisions in its tax treaties with Netherlands, Switzerland and Luxembourg imposing restrictions on the availability of tax credit refunds in the circumstances where it is clear that the corporate structure has been arranged in order to obtain such refunds. Denial of relief relating to interest or royalties have been provided in certain treaties, where the debt or right has been created or assigned in order to take advantage of the treaty rather than *bona fide* commercial reason.

The treaty shopping is attacked by introducing ;

1. anti-shopping article in the treaties (example India and US treaty, Indo-Armenia treaty and Indo-Singapore treaty as amended by protocol notified on 18-7-2005);
2. domestic legislation prohibiting or restricting the use of its treaty for shopping (example, Switzerland's 1962 anti-treaty shopping provisions).

Tax treaty between US and the Netherlands Antilles was terminated with effect from January 1, 1988 and more recently Antigua-US treaty.

Improper use of Treaty - Tax Haven countries

7.6-5A Some tax regimes are tailored in such a manner as to erode the tax base of other countries. Such practices are termed as harmful tax practices. This happens when tax regimes attract investment or savings originating elsewhere and when they facilitate the avoidance of other countries taxes. To avoid co-ordinated action for the elimination of harmful tax practices, the OECD in May, 1998, issued a report on Harmful Tax Competition and made nineteen specific recommendations, some of them are :

- (a) *Recommendations concerning domestic legislation and practices* - These include effective use of the controlled foreign corporation (CFC) or equivalent rules, restriction over participation exemption and tax exemption foreign source income on income from tax havens, extensive exchange of information under article 26, publication of advance tax rulings, adherence to the OECD 1995 transfer pricing guidelines, etc.
- (b) *Recommendations concerning tax treaties* - These include extensive use of Exchange of Information article, curbing treaty shopping, termination of existing tax treaties with tax havens, mutual assistance of tax authorities in the recovery of cross-border tax claims, etc.
- (c) *Recommendation concerning international co-operation* - These include establishment of a Forum on Harmful Tax Practices to carry out the guidelines to be prepared for dealing with harmful tax regimes, preparation a list of tax havens, development and active promotion of principles of good tax administration, etc.

The main recommendations relate to—

- Establishment of a Forum on the Harmful Tax Practices, and
- Setting the Guidelines for Dealing with Harmful Regimes in Member Countries.
- Establish much of a Forum on the Harmful Tax Practices,
- Setting forth Guidelines for Dealing with Harmful Regimes in Member Countries, and

The Forum is responsible for undertaking an ongoing evaluation of existing and proposed preferential tax regimes in Member and non-member countries, analysing the effectiveness of counteracting measures, including non-tax measures and examining whether particular jurisdictions constitute tax havens.

The Guidelines on harmful tax practices incorporate a standstill provision and a roll-back provision. Under the standstill provision the Member countries are to refrain from:-

- i. adopting new measures, and
- ii. extending the scope of or strengthening existing measures that constitute harmful tax practices.

Under the roll back provisions, the harmful features of preferential regimes must be eliminated by April, 2003.

The Forum on Harmful Tax Practices has set out guidelines so that harmful tax practices among Member States could be removed and there is co-ordination of their responses to the harmful practices of non-member countries. These guidelines which are six in number require the Member Countries to refrain from adopting new measures or extending the scope that constitute harmful tax practices, to review their existing measures for identifying harmful tax practices and report them to the Forum, to remove those measures identified and listed as harmful tax practices by the Forum in 2003, to request that measures of another member that are not listed be examined, to co-ordinate,

through Forum, their responses to harmful tax practices of non-members, to use the Forum to encourage non-members to associate themselves with the guidelines.

Tax haven countries

The factors which determine tax haven are :—

- There is no normal tax on the relevant income (from geographically mobile financial and other service activities);
- There is no effective exchange of information with respect to the regime;
- The jurisdiction's regime lacks transparency;
- Inadequate or total absence of regulatory supervision or financial disclosure;
- The jurisdiction facilitates the establishment of the foreign owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy.

Lack of effective exchange of information, lack of transparency, and, attracting business with no substantial activities are, thus, the criteria. Based on these, the OECD released in June, 2000 a list of 35 jurisdictions. It includes Andorra, Anguila, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, British Virgin Island, Cook Island (New Zealand), Dominica, Gibraltar, Grenada, Guernsey, Jersey, Isle of Mann, Liberia, Maldives, Liechtenstein, Marshall Islands, Monaco, Montserrat, Nauru, Niue, Panama, Samoa, Seychelles, St. Lucia, Federation of St. Christopher and Nevis, St. Vincent and Grenadines, Tong, Turk and Caicos, US Virgin Islands and the Republic of Vanuatu.

The following countries have committed to eliminate harmful tax practices, to embrace international standards of transparency and to exchange information and to have fair tax competition :—

Bermuda;

The Cayman Islands;

Cyprus;

Malta;

Mauritius; and

San Marino

Mauritius proposed to take the following measures in this direction :—

- 15 per cent flat rate of tax proposed for all offshore companies.
- Deemed tax credit to be diluted, eventually to be phased out;
- Greater emphasis on information exchange;
- Companies to submit audited accounts within six months of the financial year-end.

While funds registered after June 30, 1998, paid a flat rate of tax of 15 per cent in Mauritius, they also got a deemed foreign tax credit of 90 per cent of the Mauritius tax payable under the Mauritius Income-tax (Foreign Tax Credit) Regulation, 1996. This is now proposed to be diluted to 80 per cent as an initial step to phasing out. Barbados, Maldives and Tonga are excluded from this list, as not harmful.

Improper use of Treaty - Tax deviant countries

7.6-5B Treaty benefits may be denied in respect of income which is derived from activities not requiring substantial presence in their performance [such as those (a) involving banking, shipping, financing, insurance or electronic commerce, (b) involving headquarter or coordination centre etc. providing company or group administration, financing or other support, (c) which give rise to passive income such as dividends, interest and royalties] and is preferentially taxed (low or no tax) and information in relation thereto is accorded confidential treatment thus preventing effective exchange of information (*see* OECD Commentary, article 1, paragraph 21.3)

Besides tax havens, the OECD identified 47 tax preferential regimes which meet the following criteria:-

- The regime imposes low or no tax on income;
- The regime is ring-fenced from the domestic economy (It does not offer domestic entities the same tax advantage) ;
- The regime lacks transparency.

There is no effective exchange of information.

The OECD desires that harmful features of preferential tax regimes be removed and that no new measures are adopted or the existing ones strengthened, by its members. In the insurance sector, Australia, Belgium, Finland, Italy, Ireland, Portugal, Luxembourg and Sweden have been identified as having a preference tax regimes. As regards banking, the countries are Australia, Canada, Ireland, Italy, Korea, Portugal and Turkey. The other sectors where the countries are found to have preferential tax regimes are financing and leasing, fund managers, distribution centres, service centres and shipping. Recently in 2006, the OECD released a report on the progress of elimination of harmful tax practices in OECD countries. The report follows on the 2004 Progress Report and updates the assessment of the preferential tax regimes in OECD countries that were identified as potentially harmful in 2000 Report, "Towards Global Tax Co-operation". In 2000, 47 countries were identified potentially harmful preferential tax regimes. Of these, 19 have been abolished, 14 have been amended to remove their potential harmful features, 13 were found not to be harmful and only one has been found to be harmful.

Anti-treaty shopping provision - India-US treaty

7.6-6 Article 24 of the India-US tax treaty (limitation of benefits) reproduces a part of article 16 of the US Model Convention. The relief is limited to a person (other than an individual) only if—

- (a) more than 50 per cent of the beneficial interest in such person is owned, directly or indirectly, by
 - one or more individual residents of one of the contracting states, or
 - other individuals subject to tax in either contracting state on their world wide incomes, or
 - citizens of US,
- (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not residents of one of the contracting states or citizens of US.

The above limit is not applicable if the—

1. income is derived from the other contracting state in connection with, or is incidental to, the active conduct by such person a trade or is incidental to, the active conduct of by such person of trade or business (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).
2. person deriving income is a company which is resident of a contracting state whose principal class of shares there is substantial and regular trading on a recognised stock exchange.
3. competent authority of the state in which the income arises determines to grant benefits.

Thus, a person who is resident of one of the contracting States is not entitled to any relief under the treaty in other State unless one of the three following tests is satisfied:

- the person is a company in whose principal class of shares there is a substantial and regular trading on a recognised stock exchange ;
- the person is engaged in an active business in the residence state ;
 - more than 50 per cent of the beneficial interest in such person is owned directly or indirectly by any combination of one or more of the following :
 - US resident individuals;
 - US citizens;
 - Indian resident individuals ;
 - any company mentioned above

and the income is not utilised in substantial part to meet liabilities to persons who are not residents of one of the contracting States.

The above provision is a typical limitation on benefits article used in US treaties limiting benefits to the following persons (*see Cahiers de droit fiscal international, Volume LXXXIIb. The taxation of investment funds p. 49*) :

- (a) individuals who are residents of a contracting state;
- (b) contracting states and other political sub-divisions thereof;
- (c) certain tax exempt entities that are owned by requisite number of qualified residents of a Contracting State;

(d) persons resident in a contracting state if—

- (i) more than 50 per cent of the beneficial ownership interests in the persons are owned by qualified residents described in item (a), (b), (c) or (e), and
- (ii) less than 50 per cent of the person's gross income is paid out to non-residents in the form of interest, royalties or other deductible payments;
- (e) resident companies the shares of which are substantially and regularly traded on one or more recognised exchanges in either contracting state;
- (f) resident entities that are engaged in an active business in the residence state if the income derived from the other state is derived in connection with or incidental to that business;
- (g) persons obtaining a favourable ruling from the competent authority.

Anti-treaty shopping provisions - Indo-Singapore treaty

7.6-6A Indo-Singapore treaty originally entered into in 1994 has now been amended by a Protocol (2005) 146 Taxman 85 (St.) which came into effect from 1st August, 2005, providing, *inter alia*, limitation of benefit to the *bona fide* residents of treaty countries. Article 3 of the Protocol provides that the advantage under the treaty of capital gain tax with respect to capital stock of a company would not be available to—

- (1) a resident of a Contracting State if its affairs were arranged with the primary purpose to take the advantage.
- (2) a shell/conduit company, *i.e.*, a legal entity falling within the definition of resident with negligible or *nil* business operations or with no real and continuous business activities carried out in the Contracting State, meaning thereby not having *bona fide* business activities. It would be so deemed if its total annual expenditure on operations in the Contracting State is less than \$ 2,00,000 or Indian Rs. 50,00,000, as the case may be, in the immediately preceding period of 24 months from the date of capital gains arise. It would not be so done if the annual expenditure during the said period is equal to or more than said limit or it is listed on a recognized Stock Exchange of the Contracting State. The term 'annual expenditure' means an expenditure incurred during a period of 12 months. The period of 24 months shall be calculated by referring to two block of 12 months immediately preceding the date when the capital gains arise. As for (1) above, domestic anti-abuse provisions (*e.g.*, business purpose, substance-over form, step transaction or conduit principle) are applied to determine whether the primary purpose is to take advantage of the treaty provision. As for (2), it complements the domestic law by permitting the tax authorities to tear the veil of corporation to determine whether an entity is shell or conduit entity, providing, however, the objective criteria for such determination.

Anti-treaty shopping provision - Indo-Armenia treaty

7.6-6B Article 28 of the Indo-Armenia Treaty contains a limitation of benefit provision limiting the benefit under the Treaty to a resident who is a qualified person in terms of para 2 thereof. There is no qualifying requirement for an individual, Government entity, or charity or other tax exempt entities. They are entitled to treaty benefit. For other, the basic requirement is that more than 50 per cent of the beneficial interest is owned directly or indirectly by residents of the Contracting State; for example, in case of a company, by residents; pension trust, by individuals, resident, and a person other than individual, by the said individual, Government entity charity or other tax exempt entity, pension fund, company (whose shares are listed in recognised stock exchange). The additional requirement in the case of the last entity is that less than 50 per cent of the gross income is paid out to non-residents in the form of deductible payments. The provision therefore entitles the following persons to the benefits of the Treaty :

- (a) Individual who are residents of India or Armenia
- (b) Government entities
- (c) Tax exempt entities
- (d) Pension funds owned by at least 50 per cent of individuals resident of India or Armenia
- (e) Resident companies the shares of which are substantially or regularly traded on recognised exchange in India or Armenia
- (f) Person other than individual if—

- (i) more than 50 per cent of the beneficial ownership interests are owned by qualified residents described in item (a), (b), (c), (d) or (e) above
- (ii) less than 50 per cent of its gross income is paid or accrued directly or indirectly to persons who are not residents of India or Armenia in the form of deductible payments
- (g) Resident entities that are engaged in active business in the residence State if the income is derived from the other State in connection with or incidental to that business other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealers
- (h) persons obtaining a favourable ruling from a competent authority.

Treaty shopping - Domestic Law provision and LOB provision in Treaty Treaty shopping - Domestic Law provision and LOB provision in Treaty

7.6-7 Any abuse of the provisions of a tax treaty could be characterised as an abuse of the provisions of domestic laws and thus anti-avoidance rules set by domestic laws for determines a tax liability under a treaty also. There is no conflict between such laws and treaty provisions (*see* OECD Commentary, article 1, paragraph 9.2). The benefits not intended under the treaties but obtained through their abuse could be countered under the domestic anti-avoidance rules which may take many forms, such as transfer pricing rules, thin capitalization rules, CFC rules, and doctrines such as sham transactions, business purpose, substance over form doctrines. A transaction proper in form may lack economic substance beyond the creation of tax benefits and not imbued with tax independent considerations. Such a transaction is an economic sham. Taxpayers are tempted to abuse the tax laws of the State by exploiting the differences between various country's laws. Such attempts may be countered by anti-avoidance legislation such as—

- anti-avoidance legislation (discussed in chapter 38);
- substance over form (discussed in chapter 38);
- thin capitalization (discussed in chapters 15, 16, and 17);
- controlled foreign corporation legislation (discussed later).

Recent treaties now restricts access to their benefit to the legitimate residents of other country, by providing a limitation-on-benefits (LOB) provisions. Such provisions are intended to prevent treaty shopping, whereby an entity can be established without any economic connection so that access can be had and thereby benefits of the treaty obtained. The LOB prevents treaty shopping and thus tax avoidance by denying treaty benefits to unintended beneficiaries who channel their investments through entities formed in a treaty country without being residents thereof. The theory underlying such a provision is that one Contracting State should accord treaty benefits only if the recipient has a sufficient nexus with the other Contracting State.

Limiting the benefits of a treaty to the residents of the contracting State as against the third country residents, is the desire of the source state. It is not the intention of the Contracting States that a person acting through a legal entity created in a State obtains treaty benefits that would not be available directly to him. Treaty benefits may be disallowed to a company not owned, directly or indirectly, by residents of the States of which the company is a resident. Disallowance of such benefit could be inferred from article 1 which provides that the convention shall apply to persons who are residents of the contracting States. But some treaties explicitly so provide and also the criteria according to which a company would be considered as owned or controlled by non-residents, thus setting out the limitation to the benefits under the treaty. In *Cahiers de droit fiscal international*, volume LXXXVIb (2001), page 78, it is stated :

"4.2.2.3 Special limitations on the benefit of conventions

Even more precise provisions may be included in the convention to prevent "treaty shopping" by way of interposition situations in relation to persons established in third party countries.

It may be a question of a condition regarding the beneficiary's good faith, or of standard provisions of a general nature and based on objective criteria, such as, often, going beyond a holding threshold by non-residents of a company of the contracting country receiving certain income. This applies, for instance, to clauses included, at the United State's request, in the conventions negotiated or renegotiated by that country and which include a set of carefully described tests to verify that the companies of a contracting country are

not controlled by non-residents. Thus companies that are listed on the market, those that are controlled by listed companies or those that carry on real industrial or commercial activity in their country of residence may be covered by the convention. On the other hand, companies that are mere interposed screens are not covered as a general rule. When the conditions are not met, application of the convention is possible only if approved by the competent authority of the other country. Certain conventions may include clauses by which one of the contracting countries specifically approves the benefit for structures of the other country only on special conditions. That may be the case, for instance, when granting the benefit of reduced withholding rates on the dividends paid by resident subsidiaries to the parent companies if connected with a minimum holding threshold and, if the case arises, a holding period preceding the decision to pay out dividends. Certain conventions may also lay down special provisions for companies involved in the international maritime traffic by excluding, for instance, from their field of application of the profits due to non-residents of the contracting countries or which come from traffic carried out with ships not flying the flag of the country of the registered office of the company operating the ships."

The LOB clause is meant to ensure that the benefit of the treaty is enjoyed by the legitimate residents of the Contracting States. This is a look through approach which would deny treaty benefits to corporations owned or controlled by non-residents of the host country. This approach seems to be an adequate basis in relation to countries which levy no or very low taxation and where little substantive business activity would normally be carried on, subject to exception of *bona fide* business activities. It is looking beyond the corporate veil to limit the benefit to only *bona fide* residents.

A typical example of limitation of benefits rule is contained in Article 22 of the US Model Convention. That Article consists of five paragraphs. Paragraph 1 states the general rule that residents are entitled to benefits otherwise accorded to residents only to the extent provided in the Article. Paragraph 2 lists a series of attributes of a resident of a contracting State, the presence of any of which will entitle that person to all benefits of the convention. Paragraph 3 provides that, with respect to a person not entitled to benefits under paragraph 2, benefits nonetheless may be granted to that person with regard to certain types of income. Paragraph 4 provides that benefits also may be granted if the competent authority of the State from which benefits are claimed determines that it is appropriate to provide benefits in that case. Paragraph 5 defines the term "recognised stock exchange" as used in paragraph 2(c).

Paragraph 2 of Article 22 on Limitations on Benefits provides objective tests for limiting the benefits to the *bona fide* residents of the Contracting States. This Article is anti-abusive of the treaty provisions and determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes. Domestic anti-abuse provisions, e.g., business purpose, substance-over-form, conduit or step transactions are discussed in details in Chapter 38. Those principles of the source State are applied to identify the beneficial owner of an item of income, and Article 22 then is applied to the beneficial owner to determine if that person is entitled to the benefits of the convention with respect to such income. Paragraph 2 of Article provided that a resident of a Contracting State shall be entitled to all the benefits of the Convention if the resident is :

- (a) an individual;
- (b) a qualified governmental entity ;
- (c) a company, if—
 - (i) all the shares in the class or classes of shares representing more than 50 per cent of the voting power and the value of the company are regularly traded on a recognised stock exchange, or
 - (ii) at least 50 per cent of each class of shares in the company is owned directly or indirectly by the companies entitled to benefits under clause (i), provided that in the case of indirect ownership, each intermediate owner is a person entitled to benefits of the Convention under this paragraph.
- (d) described in sub-paragraph 1(c)(i) of Article 4 (Residence)
- (e) described in sub-paragraph 1(c)(ii) of Article 4 (Residence), provided that more than 50 per cent of the person's beneficiaries, members or participants are individuals resident in either Contracting State ; or
- (f) a person other than an individual, if :
 - (i) On behalf of the days of the taxable year persons described in sub-paragraph (a), (b), (c), (d), or (e) own, directly or indirectly (through a chain of ownership in which each person is entitled to benefits of

the convention under this paragraph), at least 50 per cent of each class of shares or other beneficial interests in the person; and

- (ii) Less than 50 per cent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are residents of either Contracting States (unless the payment is attributable to a permanent establishment situated in either State), in the form of payments that are deductible for income-tax purposes in the person's State of residence.

Other provisions of the Article are not reproduced. The above objective tests are intended to limit the benefits of treaty only to the residents of the Contracting States. The assumption underlying each of these tests is that a taxpayer satisfies the requirements of any of the tests probably has a real business purpose for the structure it has adopted, or has a sufficiently strong nexus to the other Contracting States (*e.g.*, a resident individual).

(Article 28 of the Indo-Armenia treaty incorporate the above tests.)

Article 24 of the Indo-US treaty incorporates sub-paragraph 2(f) of the said Article 22 of the US Model Convention. It provides two part tests : (1) ownership test, and (2) base erosion test.

The ownership prong of the test requires 50 per cent or more of each class of beneficial interests in the person (in the case of a corporation, 50 per cent or more of each class of its shares) be owned by persons who are themselves entitled to the benefits, the ownership may be indirect through other persons themselves entitled to benefits.

The purpose of the base erosion prong of the test is to determine whether the income derived from the source State is in fact subject to tax regime of that other State. It therefore requires that income of such person is not used in substantial part, directly or indirectly, to meet the liabilities (including interest or royalties) to persons who are not resident of the one of the Contracting States. Payments to any resident of either State as well as payments that are attributable to permanent establishment in either State, are not considered base eroding payments for this purpose.

Controlled Foreign Corporation (CFC) Controlled Foreign Corporation (CFC)

7.6-8 Rule Multinational enterprises have a tendency to shift their profits from a high tax jurisdiction to a low tax jurisdiction. This they do through the techniques known as "thin capitalisation", "transfer pricing", "Controlled Foreign Corporation (CFC) Rule". Under CFC Rules a non-resident or, say, a non-US resident company controlled by persons resident in the US is defined as a CFC in any accounting period in which it is subject to a lower level of taxation in the country in which it is resident say India. It is a non-resident company controlled or treated as controlled by residents of US and subject to lower level of taxation in India in terms of the Indo-US treaty.

The CFC Rule restricts the use of foreign corporations controlled by the residents of a country to defer domestic tax on foreign source income. Its purposes are, to prevent the diversion of passive income such as dividends, interest in CFCs and also accumulation thereof such passive income in excess of business needs or in a low tax country. The rule applies only to foreign corporations with a specified levels of resident's ownership, and not to other types of entities such as partnerships etc.

A common feature of controlled foreign companies provisions, which are now internationally recognized as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities (*see* OECD Commentary, article 1, paragraph 23).

Philip Baker in his book Double Taxation Agreements, explains:

"Controlled foreign corporation legislation applies in general where a resident person controls - generally through a majority shareholding - a corporation resident in another jurisdiction. The profits of the controlled corporation are liable to tax where the corporation is resident, and the country of residence of the controlling parent would normally only be able to tax distributions which are made by the controlled corporation. This creates the possibility for deferral of the tax charge in the country of residence of the controlling parent. CFC legislation combats this deferral by allowing the country of residence of the controlling parent - through one method or another - to tax income accruing to the controlled corporation even before it has been distributed. CFC legislation may operate in a number of ways : it may, for example, target only income earned by a controlled corporation in a low tax regime, or it may target particular types of 'tainted' income. The legislation may operate by attributing some or all of the income of the controlled corporation to the controlling parent, or by deeming a notional distribution to have been made by the controlled corporation."

The effect of such a legislation would be that the income of the controlled corporation could not be deferred as it could be taxed in the state of residence of its parent before distribution. The CFC rule operates on a computation of hypothetical amount which represents the profits of the controlled foreign company would have made had it been resident (*see Bricom Holdings Limited v. IRC* [1997] STC 1179). By hypothetical computation with reference to the profits of subsidiary company, the conflict between the domestic law and the treaty could be avoided.

A state has right to tax its own residents, without a conflict with the double taxation agreement. It has sometimes been argued, based on a certain interpretation of the provisions of the Convention such as paragraph 1 of article 7 and paragraph 5 of Article 10, that this common feature of the controlled foreign companies legislation conflicts with these provisions. The Contracting State right to tax its own residents is not limited under the controlled foreign companies provisions found in the domestic law even though such tax imposed on those residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (*see OECD Commentary, article 7, paragraph 10.1*). Again the OECD Commentary, article 10, paragraph 37 says "It might be argued that where the taxpayer's country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder." Based on these observations, the OECD Commentary says that the interpreting of articles 7(1) and 10(5) as indicating conflict "... that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context." However, the CFC rules should not be applied when the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer (*see OECD Commentary, article 1, paragraph 26*)

Many countries tax their resident on their worldwide income, *i.e.*, all income derived from whatever source which accrues, arises to, or is received by him (for example, *see* section 5 of the Indian Income-tax Act, 1961). Corporations in a foreign country established by those residents with the entire shareholdings are treated as independent and separate from them. Such a relationship gives a tool for manipulation of accrual or arising of income.

Investment funds - Whether a person

7.6-9 The expression "investment fund" has not been defined in the model tax treaty. Its concept has been examined in detail in paragraphs 9.14-4 and 19.14-6. An investment fund is a private collective undertaking, acting as intermediary in the financial market, which collects savings and capital from a number of investors manages them on fiduciary basis, uses such savings and capital in transferable securities such as shares, bonds, etc.

A fund may be a corporation or trust that restricts its activities to the investing of its funds and offers securities (*i.e.*, shares or units) to the public and redeemable on demand by the holder as in the case of open-end mutual fund. For a fund to have treaty access, it must first be person and then a resident in terms of the treaty and thereafter the beneficial owner of the foreign income. According to treaty provision the terms "person" includes an individual, a company and any other body of persons. If the fund is or treated like a company under the domestic laws, it is a person. Section 4A of the Indian Companies Act, 1956 recognises certain public financial institutions for the purposes of that Act. Certain others have been notified, under section 4A(2). Certain nidhis/mutual benefit societies have been notified under section 620A of that Act.

Whether and to what extent an investment fund could have access to a treaty depends on whether within the meaning of a treaty it could be regarded a person, a resident, and beneficial owner of the foreign income it receives. Such conditions could be met, if its purpose is to receive income and capital gains resulting from normal stewardship, open to a number of investors, and regulated in terms of its transparency and operation and independence. The treaty access does not depend as much on the legal form as on its openness to the public, independence of its management and effectiveness of the regulation. If a fund meets such a standard, it is taken an entity for treaty purposes. It is resident if it is liable for tax or if tax could be withheld on distribution or redemptions. The fund receives income not as a nominee or agent of the investors but as its own. It is, therefore, beneficial owner. The question of beneficial ownership may be linked to the broader issue whether the foreign fund

is taken as a separate entity for tax purposes, as a separate taxable unit or as a transparent. Some countries treat it as a domestic entity, disregarding the foreign entity's legal status and the tax treatment in its state of residence.

If fund is taxed as a body corporate (a "body of persons"), it has treaty access irrespective of whether it is a legal person under the civil law.

As regards "overseas financial organisation referred to as Offshore Fund", section 115AB of the Indian Income-tax Act defines it to mean any fund, institution, association of or body, whether incorporated or not, established under the laws of a country outside India, which has entered into an arrangement for investment in India with a public sector bank or a public financial institution or a mutual fund specified under clause (23D) of section 10 and such arrangement is approved by the Securities and Exchange Board of India for this purpose; and the expression "unit" to mean unit of a mutual fund specified under clause (23D) of section 10 of the Indian Income-tax Act, 1961 or of the Unit Trust of India. Income received by the offshore fund in respect of units purchased in foreign currency income by way of long term capital gains arising from the transfer of the units is taxable at the rate of ten per cent. Other income is chargeable at the rates specified in the relevant Finance Act. Thus, the Indian Income-tax Act treats Offshore Fund as a company and thus a person in terms of its tax treaties.

Section 115AD defines "foreign institutional investor" to mean such investor as the Central Government may, by notification in the Official Gazette specify in this behalf.

An investment fund is regarded as a person for the purposes of double taxation treaties, irrespective of its legal form. As a person, it has treaty access. For full benefit, it has further to satisfy criteria of residence and of beneficial ownership, discussed later. Income received by the foreign institutional investor in respect of securities (other than the units referred to in section 115AB) is taxable at the rate of twenty per cent, capital gains from the transfer of such securities are taxable, if short-term, at the rate of thirty per cent or ten per cent, if long-term. Other income is taxable at the rates as prescribed in the relevant annual Finance Act.

Thus, the offshore funds and the foreign institutional investors are treated like a company under the Indian Income-tax Act, 1961.

Investment fund and treaty shopping

7.6-10 To prevent access to the third party investors other than the contracting state, some treaty provides a limitation on benefits as in article 24 of the Indo-US treaty, already discussed. Those limitations are not specifically tailored to investment funds. They generally applied in respect of other provisions of the treaty, to prevent treaty access to residents of the other countries. For example, the criterion of "publicly traded" test is meant to be applied to "close-end" companies and not to "open-end" funds. For the "open-end" funds, the relevant criterion is "base erosion/ownership" test (*i.e.*, where more than 50 per cent of the beneficial ownership interests are owned by the qualified residents of the State and less than 50 per cent of the person's gross income is paid out to non-residents in the form of interest, royalties or other deductible payments). With respect to this test, it may be stated that the ownership test is difficult to apply at any given point of time because of the fluctuation of treaty - eligible holders due to share issue and redemption.

India-US treaty

7.7 Article 1 of the India-US treaty incorporates paragraphs 2, 3 and 4 of the US model. Paragraph 2 provides that the treaty will not restrict in any manner any exclusion, exemption, deduction, credit or other allowance accorded by the laws of the contracting states or by any other agreement between them. Paragraph 3 provides that a contracting state may tax its residents (as determined under article 4) and citizen as if the treaty has not come into effect. It is notwithstanding any provision of the treaty. The exception is provided in paragraph 4. These are the benefits conferred by a contracting state under the following articles—

- Article 9, paragraph 2 (Associated enterprises),
- Article 20, paragraphs 2 and 6 (Private pensions, annuities, alimony and child support),
- Article 25 (Relief from double taxation),
- Article 26 (Non-discrimination),
- Article 27 (Mutual agreement procedure),
- Article 19 (Remuneration and pensions in respect to Government services),
- Article 21 (Payments received by students and apprentices),

- Article 22 (Payments received by professors, teachers and research scholars), and
- Article 29 (Diplomatic agents and consular officers).

Person - Partnership, fiscally transparent or opaque

7.8 Partnership is treated differently for tax purposes in different countries; in some as a taxable unit and sometimes even as companies, and in other as fiscally transparent where partnership is ignored for tax purposes and individual partners are taxed on their respective share of its income. If treated in the same way under the respective domestic law of both the Contracting States as taxable unit, there is no difficulty in the application of the treaty provisions and in extending benefits. The entity is a person resident of both the States, liable to tax. But for treaty purposes, the resident status is decided by referring to article 4, which in turn would decide the jurisdiction and right of the States to tax income, under the treaty. No differential treatment, no difficulty in the application of treaty provisions and benefits.

Difficulty would, however, arise if in one State it is treated as a taxable entity and in the other a fiscally transparent entity whose income flows through the partners who are, and not the entity, subject to tax. In that case, partnership does not qualify to be resident of a State as per provision of article 4, because its income is not liable to tax. Treaty benefit could be denied to a partnership's income on the basis that neither the partnership, because it is not a resident, nor the partners, because the income is not directly paid to them or derived by them.

In such cases, the question is about the entitlement to the treaty benefits, whether partnership or partners are entitled and the relationship between the two entitlements. The question largely depends on—

- whether such a partnership is a person for treaty purposes;
- if the answer is no, how the partners in other jurisdiction would get the benefit, whether the right of partners to treaty benefit could be maintained by the source State deeming fiscally transparent partnership to be a person for treaty purposes and allocating income to partners.

The term "person" has been defined in article 3(1)(a) in the OECD Model Convention as including an individual, a company and any other body of persons. The definition is inclusive and not exhaustive. Individual, company (which expression in turn has been defined to mean body incorporate and any entity which is treated as body corporate for tax purposes), and, body of persons have been specifically mentioned. Body of persons being an entity distinct from its members, is not the same as association of persons where the identity of its members is not merged in the association. Partnership is taken to be a body of persons (*see* OECD Commentary, article 3, paragraph 2, and also *Padmore v. IRC* [1989] STC 493). The words "any other" qualifying the expression "body of persons" having reference to the preceding word "company". The body of persons should be of the same character as of a company, *i.e.*, having a personality of its own distinct from its members. If it is treated as an entity for tax purposes, it is taken to be a company, in terms of definition in article 3(1)(b).

But whether a fiscally transparent partnership which is not liable to tax because of its income flowing through to the partners could be taken person for treaty purpose and whether treaty benefits extended to the partners, has been a matter of debate and discussion before courts. The Committee on Fiscal Affairs of the OECD discussed the matter in detail in Partnership Report and made suggestions which were incorporated in the OECD Commentary, discussed below.

Partnerships - Partnership Report of the Committee on Fiscal Affairs

7.8-1 A partnership is an association of individuals that are permitted to conduct business through the guise of an activity with actual tax consequences being ultimately determined and applied at the individual level (*see Unger v. Commissioner* 58 TC 1157 [1990]). Such an association whose income is not taxed in its hands but done in the hands of individual partners on their respective shares is referred as fiscally transparent partnership. Fiscally transparent partnership does not qualify to be resident of a State because it is not liable to tax. Treaty benefit could be denied to a partnership's income on the basis that neither the partnership, because it is not a resident, nor the partners, because the income is not directly paid to them or derived by them, qualify. So that the benefit could be claimed and not denied because of the differential treatment by two Contracting States, Committee of Fiscal Affairs of the OECD (1999) analysed the difficulties in the application of the treaty provisions and made suggestions towards their resolution. It, *inter alia*, made suggestions to the effect that partnership should be considered as person within the definition of article 3(1)(a); however, a fiscally transparent partnership if so treated

by a State cannot be resident of that State for treaty purposes; that where partnership is not entitled to the benefit because it is fiscally transparent, the partners are entitled to the benefit to the extent partnership income allocated to them which is to be regarded as paid or derived by those partners; that the source State should take into account the way in which an item of income is treated in the state of residence of the taxpayer claiming the benefit, *i.e.*, broadly, the state of source State should take into account whether the state of residence treats partnership as transparent or opaque. The suggestions were incorporated in OECD Commentary, article 1. Paragraphs 2 to 6.7 deal with the matter and provide how the difficulty be resolved in the application of the treaty provision and extending benefit to partners, discussed in the following paragraphs.

Partnerships - Application of treaty, difficulties

7.8-2 The difficulties in the application of a treaty to the partnership's income mainly relate to the following issues, as could be gathered from the OECD Commentary on article 1, paragraphs 2 to 6.7—

- relating to the application of articles 1, 2 and 4 (*see* paragraph 4, OECD Commentary);
- relating to the effect that the application of treaty provisions to partnership can have on the taxation of partners (*see* paragraph 6.1);
- relating to the effect of the treaty provisions on a source State rights to tax income where the entitlement to the benefits of one or more than one treaty is different for the partners and partnership (*see* paragraph 6.2);
- relating to determination of entitlement to benefits under treaties when the partnership cases involve three States (*see* paragraph 6.5);
- relating to difficulty for the application of the treaty because of the differences in how countries apply the fiscally transparent approach (*see* paragraph 6.6);
- relating to difficulties arising from the application and interpretation of different rules of the treaty by the States to the income derived by the partnership or its partners, depending on the domestic laws of the States (*see* paragraph 6.7).

Partnerships - Application of articles 1, 3 and 4

7.8-3 The first difficulty relates to the application of articles 1, 3 and 4, defining respectively the personal scope, the expressions "person" and "resident". According to article 1 the treaty is applicable to a person (as defined in article 3) who is resident (as defined in article 4) of either of the Contracting States. While a partnership constitutes a person (OECD Commentary, article 3, paragraph 2), it may not be resident in terms of article 4 (*see* OECD Commentary, article 1, paragraph 4). If it is treated as a company or taxed in the same way, it is resident and entitled to treaty benefit. That status and also the benefit are denied to a fiscally transparent partnership; both, however, being available to partners as regards their respective shares of income of partnership (*see* OECD Commentary, article 1, paragraph 5). The application of treaty is not difficult if the source State and the residence State treat the partnerships in the same way; but difficult when they treat differently. Such different treatments give rise to questions about the taxability of partners in one State when the partnership is treated as an entity and taxed as such in the other State or about the taxability in the first State of partnership as an entity when it is treated fiscally transparent and its partners being assessed in the second State.

Partnerships - Effect of application of treaty to partnership on taxation of partners

7.8-4 The relationship between the partnership's entitlement to the benefits of a treaty and of the partners raises questions (*see* OECD Commentary, article 1, paragraph 6), which relate to taxation of partners by the residence State in respect of their respective share of income of a partnership which is taxed as an entity by the source State. Where a partnership is treated as resident of a Contracting State and taxed by it, other Contracting State may not tax the partnership but its rights is not affected to tax partners who are its own residents on their share of the income of the partnership (*see* OECD Commentary, article 1, paragraph 6.1).

Partnerships - Effect of treaty on source State's right where the entitlement to benefits is different for the partners and the partnership

7.8-5 The difficulty relates to extending treaty benefits to partners by the residence State when a partnership is treated by it as an entity but treated by the source State as fiscally transparent and therefore not taxed as such. Thus, where the source State treats a domestic partnership as fiscally transparent and therefore taxes partners on

their share of the income of the partnership, the partner that is resident of a State that taxes partnerships as companies would not be able to claim the treaty benefit with respect to the share of the partnership's income that the source State taxes in his hand. It is because that that income, though allocated to the person claiming the treaty benefits under the laws of the source State, is not similarly allocated for purposes of determining the liability to tax on that item of income in the residence State of that person (*see* OECD Commentary, article 1, paragraph 6.2)

Partnerships - Resolution of difficulties in the application of treaty

7.8-6 The difficulties as referred to in the preceding paragraphs is to be resolved in the following manner

Partnerships - Taxation by source State

The source State should take into account the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the treaty benefits as a resident and not to regard partnership as transparent for tax purposes but treat it as a separate legal entity (*see* OECD Commentary, article 1, paragraph 6.3).

Partnership - Taxation by residence State

Since the income partnership "flows through" to partners under the domestic law of the State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the treaties concluded by the States of which they are residents, even if, under the domestic law of the source State, income is attributed to the partnership which is treated as separate taxable entity (*see* OECD Commentary, article 4, paragraph 8.4). The income is appropriately viewed as "paid" to the partners since it is to them and not to the partnership income is allocated for purposes of determining tax liability in their State of residence. The partners satisfy the condition imposed in several articles, that the income concerned is "paid to" or "derived by" the resident of the other Contracting State. The partners, therefore, should be given treaty benefit in respect of income deemed to have been allocated as paid or derived by them (*see* OECD Commentary, article 1, paragraph 6.4).

Partnerships - Difficulty in the application in cases involving three States

7.8-7 Many of the problems relating to determination of entitlement to benefits in cases involving three States could be resolved in the manner as discussed in the preceding paragraphs. A situation may arise where—

1. partner is resident in one State ("residence State");
2. the partnership is established in another State ("partnership State"); and
3. the partner share in partnership income arises in a third State ("source State").

In that case, three States are involved and two treaties, one between the residence State and the source State and the second between the partnership State and source State. Under that situation the benefits may be claimed by—

- the partner of the treaty between residence State and the source State (if the partnership is not taxed in the partnership State) with respect to income allocated to him for the purposes of taxation in his residence State
- the partnership (if it is taxed as a resident in the partnership State) of the treaty between partnership State and the source State.

(*see* OECD Commentary, article 1, paragraph 6.5)

Where partnership has claimed benefit, there is a possibility of the partners making concurrent claims. In order to prevent "double benefits", the Commentary provides that Contracting States may consider making provision to ensure appropriate and simplified administration of giving the benefits—

- no benefits will be available under the treaty between the partnership State and the source State if the partnership is regarded as transparent for tax purposes by the partnership State;
- no benefit will be available under the treaty between the residence State and the source State if the income of the partner is not allocated to the partner under the taxation laws of the residence State;
- if the partnership is regarded as transparent for tax purposes by the partnership State and the income of the partnership is not allocated to the partner under the taxation law of the residence State, the source State may tax partnership income allocable to the partner without restriction.

Partnership - Difference between States how fiscally transparent approach applied

7.8-8 Difficulty for the application of the treaty may arise because of the differences in how countries apply the fiscally transparent approach. Normally under that approach, the State is expected to apply the provisions as if the partners had earned the income directly so that the classification of income for the purpose of allocative rules of articles 6 to 21 will not be modified by the fact that income flows through partnership. Difficulty may arise, however, in the application of provisions which refer to the activities of the taxpayer, the nature of the taxpayer, the relationship between the taxpayer and the other party to a transaction (*see* paragraph 6.6 of the OECD Commentary, article 1).

For example, each partner of a fiscally transparent partnership is considered to have a permanent establishment for purposes of taxation of his share of the business pro-fits derived by the partnership regardless of the time spent by himself on the building site, if the period spent on the site by the partners and the employees of partnership exceeds twelve months (*see* OECD Commentary, article 1, paragraph 19.1).

Income from employment is taxable under article 15, in the State in which it is exercised. It would not be so, but taxable in the residence State if three conditions as set out in paragraph 2 of that article, are satisfied. The second condition is that "the remuneration is paid by, or on behalf of, an employer who is not resident of" the State in which the employment is exercised. Its application becomes difficult in case the employer happens to be a fiscally transparent partnership which does not qualify to be "resident" in terms of article 4 as it is not liable to pay tax. The OECD Commentary on article 15, paragraph 6.2, provides that the concepts of "employer" and "resident" as found in the second condition are applied at the level of the partners rather than at the level of a fiscally transparent partnership.

Partnership - Difficulty due to interpretation

7.8-9 Difficulties arise from the application and interpretation of different rules of the treaty by the States to the income derived by the partnership or its partners, depending on the domestic laws of the States. The difficulty relate to the broader issue of the conflict of qualification, which can be resolved under article 23 (*see* OECD Commentary, article 1, paragraph 6.7)

Partnership - US Model Convention

7.8-10 The United States adopts a "flow through" approach and the US Model Convention, 1996, provides as follows :

"An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either of the contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of taxation law of such Contracting State as the income, profit or gain of a resident."
(Article 4(1)(d) of the US Model Convention)

The approach is similar to the "flow through" approach as mentioned in paragraph 8.4 of the OECD Commentary, article 4 and to the recommendation of Partnerships Report of the OECD Committee on Fiscal Affairs.

As aforesaid treaty benefit could be denied to a partnership's income on the basis that neither the partnership, because it is not a resident as such income is not taxable, nor the partners, because the income is not directly paid to them or derived by them. So that the benefit should not be denied to the partners who are the appropriate persons to claim, this provision deems a person to have derived income from such a fiscally transparent entity. By such deeming, becomes entitled to the treaty benefit. The Technical *Explanation* illustrates : "For example, if a U. S. corporation distributes a dividend to an entity that is treated as fiscally transparent in the other State, the dividend will be considered to be derived by a resident of that State to the extent that the taxation law of that State treats residents of that State as deriving the income for tax purposes. In the case of a partnership, this normally would include the partners of the entity that are residents of that other Contracting State." This position remains unchanged even if the resident is not subject to tax on that particular income.

Person - Trust

7.9 The rule of a fiscally transparent partnership also applies to a trust. It is a person by virtue of the inclusive definition of the expression in article 3, as a partnership is taken to be a body of persons as per OECD Commentary, article 3, paragraph 2. A trust is an obligation annexed to the ownership of property and arising out of confidence reposed in and accepted by the owner, or declared or accepted by him, for the benefit of another called beneficiaries. It is a right of property, personal or real, held by one person (trustee) for the benefit of another (beneficiary). There are some other obligations which are not trust but are akin to trust. Such obligations establish a

fiduciary relationship. A fiduciary relationship exists where one person obtains property or other advantage which justice or equity requires should belong to another, or where a person reposes trust, confidence or reliance on another, or where one person has a legal title and/or control over the property or other advantage while the beneficial ownership vests in another, or where a person undertakes to act in the interest of another person, or where a person has discretionary power to change the legal position of another and that discretion exists because someone has entrusted the fiduciary to exercise. The fiduciary is bound to hold for the beneficiary the gains or the advantages arising from the fiduciary relationship.

As the trustees who deal with the properties of the trust, the identity of the settler or the beneficiaries are not disclosed in the transaction. Even the trustees' identity is obscured where they hold the trust property indirectly through one or more corporate entities. Thus, in law, the trustees are the owner of the property held in trust and also the income arising therefrom. A property can be said to be held in trust for the purpose the trust is created and not for the purpose the trustees may utilize the income.

Trust is not a legal person but, as aforesaid, set of obligations and rights. Normally it is not subject to tax at the entity level. It is a conduit, and its income is taxed directly on the beneficiaries who are entitled to income derived through the trust. The trust is, thus, fiscally transparent, its income flowing through to the beneficiaries. The same rules as those of fiscally transparent partnerships apply to the trusts to the extent that they are fiscally transparent in their beneficial owner's State of residence. For example, as Technical *Explanation* (U.S. Model Convention) explains, if X, a resident of the other Contracting State, creates a revocable trust in the names of persons resident in a third country as beneficiaries of the trust, X would be treated as the beneficial owner of the income derived from the United States under the US Code's rules. If the other State had no rules comparable to those rules then it is possible that under the laws of the other State neither X nor the trust would be taxed on the income derived from the United States. In such cases, income derived would be regarded as being derived by a resident of the other State, in the same manner as the partners are deemed to be doing in case of a transparent partnership.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - TAXES COVERED

ARTICLE 2

TAXES COVERED

- 1. This Convention shall apply to taxes on income (and on capital) imposed on behalf of a Contracting State or of its political sub-division or local authorities, irrespective of the manner in which they are levied.*
- 2. These shall be regarded as taxes on income (and on capital), all taxes imposed on total income, (on total capital) or on elements of income (or of capital) including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.*
- 3. The existing taxes to which the convention shall apply are in particular :*
 - (a) (in State A) :*
 - (b) (in State B) :*
- 4. The convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the convention in addition to, or in place of the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of significant changes which have been made in their respective taxation laws.*

8.1 The two questions relevant for avoidance of double taxation of a person who is resident of one or both the contracting states *viz.*, whether the treaty is binding on the taxing state and whether a particular taxpayer is entitled to treaty benefits, have already been discussed. The third, whether the treaty applies to the tax in question, is the subject-matter of discussion in this chapter. Article 2 of the tax treaty defines the covered taxes. Paragraph 1 covers all taxes on income or capital levied by state or its political sub-divisions or local authorities, irrespective of the manner in which they are levied. Paragraph 2 defines the expression "all taxes on income or capital". Paragraph 3 specifies what taxes are covered at the time treaty is signed. Paragraph 4 obliges the competent authorities of the respective states to update and inform each other of changes which have been made in their respective taxation laws, at the end of each year. The article is intended—

- to make the terminology and nomenclature relating to the taxes covered by the Convention more acceptable and precise;
- to ensure identification of the Contracting States' taxes covered by the Convention;
- to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political sub-divisions or local authorities;
- to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified; and
- to ensure for each Contracting State notification of significant changes in the taxation laws of the other State.

(see OECD Commentary, article 2, paragraph 1)

Taxes - On income or capital

8.2 Paragraph 1 defines the scope of application of the convention and covers all taxes on income or capital imposed on behalf of the contracting state or its political sub-divisions or local authorities, irrespective of the manner in which they are levied. The expression "all taxes on income and on capital imposed" has been defined in paragraph 2 as taxes imposed on total income, on total capital, or on elements of income or capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation. The definition covers taxes on income or capital. Tax on income is normally understood to mean "income-tax" and on capital "wealth-tax". A tax which is not charged in respect of income or capital but in respect of some other event, is not covered. For example, gift-tax on making gift, estate duty on a person dying, excise duty on manufacturing, customs duty on importing, sales tax on sale, service tax on providing services or turnover tax on turnover, are not covered. Social security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received are not regarded taxes on the total amount of wages (see OECD Commentary, article 2, paragraph 3). Similarly, royalties in respect of extraction of natural resources are not regarded taxes (see *Ashanti Goldfields Corporation Limited v. Merrifields* [1934] 19 TC 52 (UK)). Interest and penalties in respect of taxes on income or capital being in the nature of taxes, are covered. Taxes covered are those imposed by the State itself or its political sub-divisions or local authorities. It is immaterial on behalf of which authorities it is done. It is also immaterial how it is done, by direct assessment or by deduction at source, in the form of additional taxes or surtax. The scope of the article covers.

1. Taxes imposed on
2. Total income
3. Irrespective of manner in which levied.

The concept of total income is discussed later.

Taxes imposed

8.3 Imposition of tax means levy of income-tax on the income of the concerned person. It merely means the charging section and the computation section of the source state. The components which enter into the concept of tax are well known. The first is the character of the imposition known by its nature which prescribes the taxable event attracting the levy. The second is the clear indication of the person on whom the levy is imposed and who is obliged to pay tax. The third is the rate at which the tax is imposed. The fourth is the measure or value to which the rate is to be applied for computing the tax liability. If these components are not clearly and definitely ascertainable it is difficult to say that the levy exists in point of law. Any uncertainty or vagueness in the legislative scheme

defining any of these components of the levy is fatal to its validity—*Govind Saran Ganga Saran v. CST* [1985] 155 ITR 144 (SC).

Tax liability - Three stages

8.3-1 There are three stages of tax liability. There is a declaration of tax liability, that is to say that the statute determining those persons, in respect of what property, are liable. Next, there is assessment. Liability does not depend on assessment. That is, ex-hypothesis has already been fixed. Lastly, comes the method of recovery, if the person does not voluntarily pay - *Chatturam Horilram Ltd. v. CIT* [1955] [27 ITR 709](#) (SC). The tax liability comes into existence on the last day of the previous year relevant to the assessment year—*CWT v. Kantilal Manilal* [1985] [152 ITR 447](#) (SC). Income-tax is charged for any assessment year in respect of the total income of the previous year relevant to the assessment year, in accordance with the provisions of the Income-tax Act. There is a good difference between income being liable to tax and tax being assessed and charged on income—*CIT v. M.K. Kirtikar* [1959] [36 ITR 360](#) (SC). It is not possible to construe the tax chargeable as connoting the tax determinable on the basis of the total income of the taxpayer as assessed in accordance with the provisions of the Act. Tax determinable may turn out to be *nil* because of allowances or admissible deductions or expenses or other deductions or prior losses, if any, carried forward - *CIT v. India Sea Foods* [1976] [105 ITR 708](#) (Ker.). The three stages are:—

1. Determination of the persons liable to tax;
2. Assessment of tax;
3. Collection of tax.

"Persons liable to tax" is discussed elsewhere. Assessment and collection of tax relate to the manner of levy of tax.

Taxes - Manner in which levied

8.4 Paragraph 1 of article 2 states that the convention applies to taxes on income irrespective of the manner in which they are levied. The method of levying the taxes is not relevant. It may be done by direct assessment or by deduction at source or as additional taxes. Imposition of tax, as aforesaid, means levy of income-tax on the income of the liable person. Since the primary objective of the parties to the double taxation agreement is to facilitate the activities of the taxpayers who may be liable to tax under laws of both states and relief in the purpose, one must look to those profits or surpluses which by the internal laws of both the parties are subject to taxation - *Ostime v. Australian Mutual Provident Society* 38 TC 492.

Tax liability under the domestic law first examined and then modified according to tax treaty

8.4-1 Tax liability according to domestic law has first to be examined. Tax agreement being a *lex speciali* in relation to domestic laws, has to be applied in addition to or even beyond for establishing liability. Agreement provisions have to be superimposed upon those of the domestic laws and to the extent of conflict, the former prevails—*CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP). The Tax agreement acts like a stencil that is placed over the pattern of the domestic law and covers certain parts. If the tax treaty is to be applied, the particular object must be first indicated such as "income" "profit" or the "property". Thereafter, the tax object, *viz.*, the person who receives the income or the profits.

Another connecting factor between him and the state is determined, either by the characteristic of the taxpayer, such as residence, or by characteristic of the transaction or event, such as the situs of real property. The amount of tax liability is to be measured, then, *i.e.*, the manner in which the taxes are levied.

Tax under the domestic law is only one tax (classification of income and tax treaty)

8.4-2 Income-tax under the domestic law is only one tax on the sum total of the income classified and charged under the various enumerated heads such as, salaries, income from house property, profits and gains from business or profession, capital gains, and, income from other sources. The income is thus classified according to the character of the source, for the purpose of providing for each head appropriate rules for computing the amount of income. Whatever may be the head and by which income is measured, a tax will remain a tax on income. By such classification, income-tax is not taken to mean a collection of distinct taxes levied separately on each head of income. In other words, assessment to income-tax is one whole and not a group of assessments on different heads

or items of income. The pattern of domestic taxation law is that first total income is charged, its range is then defined, it is classified and then quantified.

Almost similar is the pattern of a tax treaty. Chapters I and II regulate the requirements for the application of the treaty (scope of the convention, taxes covered, essential definitions of the treaty terms); Chapter III contains the distributive rules regarding income-taxes. It is organised according to the types of income, such as, income from activities, business, shipping and aircraft, personal services (dependent and independent, entertainers and sportsperson), income from assets (dividends, interest, royalties, and, immovable properties), capital gains, and income other than these. Such designation of income in the treaties be not confused with classification of income under the domestic laws. Any resemblance is coincidental and superficial. For each category of income rules have been provided for determination of the tax claim of the contracting states. Dividends, interest or royalties are exception. If received *via* permanent establishment income is taken as business income.

Tax - Legal basis provided by tax treaty and procedure for enforcement by domestic law Tax - Legal basis provided by tax treaty and procedure for enforcement by domestic law

8.4-3 Double taxation agreement provides the legal basis. The domestic law provides procedure for enforcement of the legal rights law, if the agreement does not do. The manner of imposing tax is not important, whether done directly, collected or withheld at source, whether done presumptively on turnover, purchase, or sale or measured by any other mode. Since the double taxation agreement provides relief it modifies the tax imposed under the domestic law to restrict the claim of the source state. Various reliefs have been provided, according the nature of income as classified under the agreement. There is a special provision for taxing the business profit. It is taxed if there is a permanent establishment and only to the extent which is attributable to that establishment. There are special rules for computation of business profits and other incomes:—

- Business income (articles 5, 7 and 9 of the OECD model)
- Transport business (article 8)
- Professional profits [articles (which has since been deleted) 14 and 17]
- Employee income (articles 15, 16, 18 and 19)
- Payments to students (article 20)
- Dividends (article 10)
- Interest (article 11)
- Royalty and similar payment (article 12)
- Capital gains (article 13)
- Other income (article 21)

The above could be classified into four broad categories;

1. Income from activities such as business and dependent and independent services;
2. Income from assets, such as dividends, interest, royalties, immovable property;
3. Capital gains;
4. Income other than the above.

Different rules are provided for the computation of income and tax with respect to each category. There are however, exceptions. For instance, rule governing shipping and aircraft is an exception to the business profit rule. Rule governing entertainers and sportspersons is exception to independent and dependent services. In case of overlapping, rule governing asset has precedence. Dividends and interest are governed respectively by articles 10 and 11, rather than under article 7, in case of a business enterprise. The precedence rule has a very important exception. The taxation is governed by article 7, if the dividends, interest or royalties are received in the other contracting state through permanent establishment.

Tax and taxationTax and taxation

8.5 The two expressions which are frequently used in the tax treaties are "taxation" and "tax". They are not interchangeable. They connote different meanings. "Taxation" according to Black's Law Dictionary is the process of taxing or imposing a tax. The New Webster's Dictionary and Thesaurus (1992) defines it, "The imposition of tax; the system by which taxes are imposed : the revenue obtained by imposing taxes". The distinction between the

two expressions becomes clear if the object clause of a tax treaty is read. Its normal purpose is "avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital". The expression "taxation" has been used in article 23 (which lays down the manner in which the double taxation has to be avoided) and in article 24 (which seeks to prevent discrimination in taxation). Article 10 provides that "this paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid". Article 11 provides a ceiling on the charge of tax in respect of each contracting states and lays down that "the tax so charged shall not exceed 10 per cent of the gross amount of the interest". Thus "taxation" relates to the manner of imposing tax, *i.e.* the process of taxing. The expression "tax" refers to charge of income, and the expression "taxation", to the quantification of the charge. Some of the articles in the treaty uses the expression "rate of tax". Wherever it is so done, the language employed in that "the tax so charged" shall not exceed the percentage as specified (*see* articles 10, 11 and 12). Rate of tax are prescribed with reference to the total income of the person which is charged to tax. Tax has first to be charged on income, and thereafter restricted to the percentage as prescribed in the tax agreement. The manner of taxation includes the rate of tax.

Tax and rate of tax

8.6 Tax treaty is not capable *per se* of creating or increasing a tax rate. Its function is to limit the authority of the Contracting States to tax income. The expressions "tax" and "taxation" do not mean "rate of tax". These three are being used distinctively in a tax treaty, conveying different meanings. Income is first charged to tax. It is there-after computed. The amount of tax is determined by applying some rates to the computed income. Under the Indian Income-tax Act, a large number of concessions are given to a foreign company with regard to the manner of computation which are not available to an Indian company. An Indian company pays tax on its total income whereas foreign company is liable to pay tax in respect of income which accrues or arises in India. Section 115A contains certain special provisions for tax on dividends, royalties and technical services fees in case of foreign company. Special concession has been given to non-resident sportsmen. The surcharge imposed by annual Finance Act is payable only by a domestic company and not a foreign company. A reading of article 8B of the UN model (profits from shipping, inland waterways and air transport) makes the distinction clear. It lays down the "profit to be taxed shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by.....per cent (The percentage is to be established through bilateral negotiation)". Income from shipping is to be charged to tax, then profit are determined and thereafter the amount of tax by the application of some rate. All the stages are embraced in the word "levy" which expression means the entire process of imposing the charge, assessment of income, assessment of tax, as well as collection of tax.

An *Explanation* has been added to section 90 of the Indian Income-tax Act, 1961 (Finance Act, 2001, w.e.f. 1-4-1962), to the effect that a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as a less favourable charge or levy of tax in respect of such foreign company, where such foreign company has not made the prescribed arrangement for declaration and payment within India of the dividends (including dividends on preference shares) payable out of its income in India.

Taxes Covered (Income-tax and Surcharge) - Existing

8.7 Paragraph 3 lists the existing taxes to which the agreement is to apply. In respect of India, the taxes mentioned are income-tax and any surcharge thereon, if any. Surcharge is imposed every year, under the Finance Act, which is in addition to income-tax. For example, Paragraph E of Part 1 of First Schedule of the Finance Act, 2003, provides rate of income-tax in the case of a company which in the case of foreign company is 40 per cent and surcharge thereon calculated at the rate of five per cent. Surcharge is only levied in respect of the income-tax computed in accordance with the said paragraph E. It is not done in respect of any other income, as, for example, in case of dividend, interest and royalties under section 115A of the Income-tax Act, 1961. Further, under the double taxation agreements, maximum rate of tax has been provided in respect income by way of dividend, interest and royalty for the source State. That rate has been mandatorily provided overriding provision of section 115A of the Act and also of the Finance Act, which cannot be modified and enhanced. It is final. No surcharge in addition to the rates as provided in the double taxation agreement, can be charged. The list of taxes in force at the time of signature of the treaty illustrates paragraphs 1 and 2 and is not exhaustive. In principle, it is a complete list of taxes imposed in each State at the time of signature and covered by the treaty (*see* OECD Commentary, article 2, paragraph 6). A left out is not, but a new subsequent identical or substantially similar to taxes to which treaty applies is, covered. It may be

a tax and not an imposition similar to tax, *e.g.*, royalty payment (*see Ashanti Goldfields Corporation Limited v. Merrfields* [1934] 19 TC 52 (UK))

Subsequent taxes - Identical or substantially similar

8.8 Paragraph 3 gives a list of the taxes in force at the time of signing the agreement, which are covered. Paragraph 4 extends that list to taxes subsequently imposed, which are identical or substantially similar. The only requirement is that such subsequent taxes are to be notified to the other Contracting State, at the end of each year. Whether the subsequent imposition is identical or substantially similar, dispute may arise which can be resolved under the Mutual Agreement clause.

Cahiers de droit fiscal international, Volume LXXXVIb, 2001 San Francisco Congress refers to a dispute about tax imposed subsequently to the signing of an agreement between Sweden and Malaysia, at page 835 :

"When Sweden concluded that treaty the general company tax rate in Malaysia was about 40 per cent. In 1990 Malaysia introduced a low tax regime on Libyan Island, located in the South Chinese Sea just off the Sultanate of Brunei. The tax rate is minimal for companies registered on Libyan Island. Sweden opened negotiations with Malaysia on a new tax treaty excluding "Labuan companies" from the benefits of a future treaty. Malaysia was unwilling to accept this. Instead of a new treaty, Sweden unilaterally declared that Malaysian companies subject to such low-tax regimes were not covered by the scope of the present treaty. It should be stressed that, from a Swedish governmental perspective, this unilateral declaration only meant a clarification of what could be deduced from the interpretation of the treaty or 1970 with Malaysia. As that treaty does not contain the equivalent to article 1 ("Person covered") of the present OECD Model Convention, the Swedish Government argued that the personal scope is to be determined in the light of the taxes covered by the treaty. It is therefore understood that persons subject to such taxation are not covered by the scope of the treaty. Furthermore, it has also been to be argued that the unilateral Swedish declaration did in fact constitute tax treaty override (cf. Peter Sundgren, *Efterlevnad av traktateer*, SN 1995, p. 465)

It should be noted that a new treaty with Malaysia, said to exclude "Labuan companies" and their like from the scope of the treaty, has been signed but is not yet in force."

Significant changes in the taxation laws are required to be notified by the Contracting State, *i.e.*, changes which are of significance to the operation of the treaty.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - DEFINITIONS

ARTICLE 3

GENERAL DEFINITIONS

1. *For the purposes of this Convention, unless the context otherwise requires :*

- (a) *the term "person" includes an individual, a company and any other body of persons ;*
- (b) *the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes ;*
- (c) *the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State ;*

- (d) *the term "international traffic" means any transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State ;*
- (e) *the term "competent authority" means :*
- (i) *(In State A) :*
- (ii) *(In State B) :*
- (f) *the term "national" means :*
- (i) *Any individual possessing the nationality of a Contracting State.*
- (ii) *Any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.*

2. *As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has at the time under the law of that State for the purposes of the taxes to which Convention applies, any meaning under the applicable tax laws of that state prevailing over a meaning given to the term under other laws of that State.*

IntroductionIntroduction

9.1 Chapter II of the OECD/UN Model deals with interpretation of terms used in the text of a tax treaty. Article 3 groups terms together with the general provisions required for their interpretation. Separate articles are provided for some important. Article 4 defines the term "resident", and, article 5, permanent establishment. The meaning of certain terms appearing in other classified articles are provided in those articles, such as, "immovable property", "dividends", "interest", "royalties", "fee for technical services". These expressions have been defined as to "mean", or "to include" or "does not include". Article 3(1) of the UN model suggests six general definitions ("person", "company", "enterprise of a contracting state", "international traffic", "national" and "competent authority"); the OECD model, seven, adding one more to the list. The definition of the expression "national" was previously contained in article 24(1) (Non-discrimination) of the 1977 model. It has now been generalised. The OECD model added one more; "business" to include performance of professional services and of other activities of one independent character. It was necessitated because of the deletion of Article 14. Rule of general interpretation is contained in article 3(2). Any term not defined will have the meaning which it has under the law of the contracting state to which the treaty is applied. Both the paragraphs are limited by the clause "unless the context otherwise requires" providing contextual flexibility.

Definition - Delimits the meaningDefinition - Delimits the meaning

9.2 Definition is a statement that sets forth and delimits the meaning of a word, phrase or other symbolic expression as used in a given discourse or context. Definitions serve to instruct persons who are ignorant or uncertain of a usage, to determine the consistency of usage and reasoning in which a symbol or term is used and to help systematise a body of knowledge.

Definition - FunctionsDefinition - Functions

9.3 Definition performs two functions, namely, (i) the avoidance of ambiguities; and (ii) the avoidance, by means of abbreviation of tedious repetitions. The principal function of the definition is to sheer away some of vagueness and ambiguity which would otherwise surround the terms defined.

If a definition is provided to an expression, the courts are not free to construe the expression otherwise unless it is so warranted by the use of the expression such as 'except otherwise provided' or 'except if the context otherwise indicates'— *S. Sundaram Pillai v. V.R. Pattabiraman* AIR 1985 SC 582.

Definition - Does not take away ordinary meaning Definition - Does not take away ordinary meaning

9.4 An interpretation clause which extends the meaning of a word does not take away its ordinary meaning. It is not meant to prevent a word from receiving its ordinary, popular and natural sense meaning whenever that would be properly applicable, but to enable the word as used in the statute when there is nothing in the context or the subject-matter to the contrary, to be applied to something to which it would not ordinarily be applicable - *CGT v. N.S. Getti Chettiar* [1971] [82 ITR 599](#) (SC).

Definition - Absence of words and expression Definition - Absence of words and expression

9.5 In the absence of any definition, a word or expression must be given the same meaning which it receives in ordinary parlance or is understood in the sense in which people conversant with the subject-matter of the statute understand it. It is hazardous to interpret a word in accordance with the definition in another statute or statutory instrument and more so when such statute or statutory instrument is not construed as used in taxing statute or a notification issued thereunder. It should be understood in its commercial sense - *MSCO (P.) Ltd. v. Union of India* AIR 1985 SC 76.

Definition - Person Definition - Person

9.6 A tax treaty applies to persons who are residents of one or both the contracting states. The expression "person" is defined in article 3(1)(a). He is the treaty subject, entitled to the benefit under the treaty and also to be eligible to claim relief under article 25 (Mutual Agreement Procedure). The treaty entitlement flows from determination whether the "person", as defined in article 3, is "resident", as defined in article 4. The expression has been defined to include :

1. an individual;
2. a company, which under article 3(1)(b) includes:
 - body corporate; or
 - any entity which is treated as body corporate for tax purposes;
3. any other body of persons.

The definition is not exhaustive. It has to be read as indicating that the term "person" is used in a very wide sense (cf article 1 and article 4).

The definition may vary if the context so requires. The context may permit departure from the strict adherence to the treaty language. The definition is open if the context so demands. There is a degree of freedom to the court (*see Beswick v. Beswick* [1967] 3 WLR 932, where the House of Lords relied on the formulation of "unless the context otherwise requires" to correct an apparent editing mistake).

Definition - Individual Definition - Individual

9.7 Individual means a natural person, *i.e.*, a human being. It does not necessarily and invariably refer to a single natural person. Whether an entity other than the natural person is deemed to be individual depends upon the domestic laws of a country and the context. The expression "individual" does not mean only a human being but is wide enough to include a group of persons forming a unit, if the context so requires—*CIT v. Deepak Family Trust No. 1* [1995] [211 ITR 575](#) (Guj.). In *CIT v. Shri Krishna Bandar Trust* [1993] [201 ITR 989](#) (Cal.), trustees were taken individual and assessed as such. Under the Indian Wealth-tax Act, 1957, even the corporation constituted under a Central or Provincial or State Act was taken individual—*Indian Jute Mills Association v. CWT* [1996] [219 ITR 169](#) (Cal.). The Supreme Court held in *Banarsi Dass v. WTO* [1965] [56 ITR 224](#) (SC) that "individual" means as including a group of persons forming a unit. The Madras High Court held in *Coimbatore Club v. WTO* [1985] 153 ITR 172, that a club is to be treated "individual" because the word "individual" includes within its meaning plurality of individuals or body of individuals forming a single collective unit knit together by ties of common and joint interest without profit motive but owning a property. The representative person in the case of a discretionary trust was regarded individual in *Niti Trust v. CIT* [1996] [221 ITR 435](#) (Guj.).

The word "individual" in entry 86 of List I of the Seventh Schedule to the Indian Constitution takes, within its sweep, groups of individual - *Banarsi Das v. WTO* [1965] [56 ITR 224](#) (SC), a University, a bar council, trustees of a baronetcy trust incorporated by Baronetcy Act, *CIT v. Sodra Devi* [1957] [32 ITR 615](#) (SC), hospitals, library, a service club, a local body, a research institute, a university, a pinjrapole, a chamber of commerce, as individual—*Bangalore Water Supply & Sewerage Board v. A. Rajappa* AIR 1978 SC 548. Thus, the word "individual" includes within its connotation all artificial juridical persons—*Jogendra Nath Naskar v. CIT* [1969] [74 ITR 33](#) (SC). Such was the position under the Indian Income-tax Act of 1922. It is not so under the 1961 Act; an individual is referable only to natural person *Udham Singh v. CIT* [1988] [171 ITR 471](#) (Orissa).

Definition - Group of persons - A person Definition - Group of persons - A person

9.8 A group of persons having common interest of any kind carrying on an economic activity and constituting a unit commonly recognised as having separate and distinct existence is called a business entity or enterprise. Such group of persons for treaty purposes is a person. A person or group of persons may work in more than one capacity. The Income-tax law recognises dual capacity of person or group of persons. In respect of a property, these are co-owners; in a company, shareholders; in a partnership firm, partners. They might also form an association of persons to carry on an activity of profit. All these can go on simultaneously. The very same persons may receive income as co-owners, as shareholders, as partners, or as members of association. Their status in respect of a particular income does not affect their status in respect of other income. Therefore, besides an individual, a company, a partnership firm, an association of persons are person for treaty purposes. The treaty recognises the following category of groups as person:

1. company,
2. body corporate,
3. entities which are treated as body corporate for tax purposes,
4. any other body of persons,

2 and 3 above are deemed to be company.

The definition under Article 3 is drafted with special regard to the Article on dividends. The term "company" has a bearing only on that Article, paragraph 7 of Article 5 (OECD Model), and Article 16 (*see* paragraph 3 of OECD Commentary).

Definition - Company

9.9 An association of individuals formed for some purpose is called a company, if incorporated, according to the Companies Act, 1956 with perpetual succession and a common seal. On incorporation the company is regarded as a legal person, separate and distinct from its members, just as much as an individual, with no physical existence. The property of the company belongs to it and not to the individuals. The individual member has a right to receive dividend and a right to attend meetings and vote. In the case of the limited companies the liability of each member is limited to the extent of nominal amount of share held by him. In case of a company limited by guarantee, each member undertakes, in the event of the company being wound up, such amount not exceeding specified amount as may be required for payment of debts of the company, and also the costs, charges and the expenses of the winding up and for adjustment of the rights of the contributors among themselves. Prohibition of invitation to the public to subscribe to any share in, or debenture of the company, restriction on the members to transfer shares, and limiting the members to 50, are some of the characteristics of a private company. A company which is not private is a public company.

Definition - Body corporate

9.10 Body corporate is an entity to which the legal system attributes legal capacity to some general extent that it does to an individual. For treaty purposes, it is a person. It is taxed as such. Its income or property is not attributed to its beneficial owners or interested parties. A corporation may be the creature of a statute, created under a Central or Provincial or State Act, and is treated as an individual—*Indian Jute Mills Association v. CWT* [1996] [219 ITR 169](#) (Cal.). Foreign states, their political sub-divisions and local authorities are body corporate. Crown is a person—*Madras Electric Supply Corporation Ltd. v. Boarland (Inspector of Taxes)* [1955] 27 ITR 612 (HL). Government is also a person—*CIT v. Warner Hindustan Ltd.* [1986] [158 ITR 51](#) (AP).

Definition - Company and body corporate

9.11 The true legal position in regard to the character of a company or body corporate is well known. In law it is equal to a natural person and has a legal personality of its own. It is separate from that of its shareholders. It bears its own name and has a seal of its own. Its assets are separate and distinct from those of its members. It can sue and be sued exclusively for its own purpose. Its creditors cannot obtain satisfaction from the assets of its members. The liability of the members and the shareholders is limited to the capital invested by them. Similarly, the creditors of the members have no right to the assets of the corporation. This position has been well-settled ever since the decision in the case of *Salomon v. Salomon & Co.* [1897] AC 22; and indeed, it has been the well recognised principle of common law. However, in the course of time, the doctrine that the corporation or a company has a legal and separate entity of its own has been subjected to certain exceptions by the application of the fiction that the veil of the corporation can be lifted and its face examined in substance. The doctrine of lifting the veil thus

marks a change in the attitude that law had originally adopted towards the concept of separate entity or a personality of the corporation. As a result of the impact of the complexity of economic factors, judicial decisions have sometimes recognised exceptions to the rule about the juristic personality of the corporation - *Tata Engg. and Locomotive Co. Ltd. v. State of Bihar* AIR 1965 SC 40. The court is entitled to lift the veil of corporate entity and pay regard to the economic realities behind the legal facade—*CIT v. Shri Meenakshi Mills Ltd.* [1967] [63 ITR 609](#) (SC). Corporate entity is disregarded if it is used for tax evasion or to circumvent tax obligation—*Firestone Tyre and Rubber Co. Ltd. v. Lewellin (Inspector of Taxes)* [1958] [33 ITR 741](#) ; [1957] 1 WLR 464 (HL). Where a subsidiary is wholly owned by the principal company which has pervasive control over it and the former acts as the hand and voice of the latter, the subsidiary in that event would be nothing but an instrumentality, rather a part, of the principal company. The two in that event would have to be treated as one concern—*U.K. Mehra v. Union of India* AIR 1994 Delhi 25, *LIC v. Escorts Ltd.* AIR 1986 SC 1370 and *State of UP v. Renusagar Power Co.* AIR 1988 SC 1737. In the context of international taxation this doctrine is applied when treaty shopping, transfer pricing, or evasion of tax is suspect.

Definition - Local authority a corporate body

9.12 Local authorities are legal persons as a corporate body. They are not merely governmental agencies, but are legally independent entities. Local authority means a municipal committee, district board, body of port commissioners, or other authority legally entitled to, or entrusted by the Government with, the control or the management of a municipal or local fund. Legal entitlement to control and manage of municipal or local funds is the essential feature. It has legal independent existence. It functions in a defined area and is ordinarily, wholly or partly, directly or indirectly, elected by the inhabitants of the area. It enjoys a certain degree of autonomy with freedom to decide for itself questions of policy affecting the area administered by it. It is entrusted by the statute with such governmental functions and duties as are usually entrusted to municipal bodies, such as those connected with providing amenities to the inhabitants of the locality, like health, and education services, water and sewerage, town planning and development, roads, markets, transportation, social welfare services, etc. Broadly, it may be stated that it is entrusted with the functions which would otherwise be governmental duties and functions. Finally, it must have the power to raise funds for the furtherance of its activities and the fulfilment of its projects by levying taxes, rates, charges or fees. This may be in addition to moneys provided by Government or obtained by borrowing or otherwise. What is essential that the control and the management of the fund must vest in the authority - *Calcutta State Transport Corporation v. CIT* [1996] [219 ITR 515](#) (SC).

Definition - Entity treated as body corporate for tax purposes

9.13 Body corporate, as aforesaid, is deemed to be a company. An entity possessing the following characteristics is either a company or body corporate:

- An exclusive name;
- Continued existence;
- Paid-in capital;
- Limited liability;
- Overall control vesting in directors.

There are some other entities which have some of the above and not all. The legal system, however, grants them partial legal capacity. They are empowered by law or custom to own property or transact business. They are treated as bodies corporate for tax purposes and deemed company on the terms of article 3(1)(b). Their income or property is not attributed to the individual members. They are taxed as such as one entity. For example, a foundation may fall within the meaning of the term "person". Partnerships will also be considered to be "person" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons (*see* OECD Commentary, article 3, paragraph 2)

Definition - Partnership body corporate for tax purposes

9.13-1 A partnership is an association of two or more persons as co-owners of business and relation between them who have agreed to share the profits of business carried on by all or one any of them acting for all. Such persons are individually called "partners", and collectively, "a firm". A firm name is given compendiously to a group of

people who comprise its partners. Firm is different from the firm's name. Firm's name is merely an expression, only a compendious mode of designating persons; whereas, a firm is a compendium of persons who agree to carry on a business in partnership—*CIT v. Jagjit Singh Jaspal Singh* [1989] 176 ITR 276 (Punj. & Har.). Firm is a name and partnership is an agreement. In a partnership the relation arises from contract and not by status. Though the partners are collectively referred to as a firm, the mercantile view generally looks upon it as a body distinct from the members, having rights and obligations of its own. The legal notion of the firm is different. The legal view is that the firm is not recognised as distinct from the members comprising it. In fact law ignores the firm and looks to the partners for its identity and composition. The rights and obligations of the firm are really the rights and obligations of the individual members constituting it. It is neither a legal entity, nor an artificial person, nor a corporation, though law provides, probably for convenience, for the firm name being utilised for the purpose of suing and of being sued—*Iyanar Coffee & Tea Co. v. CIT* [1970] [78 ITR 775](#) (Mad.). Under the Indian Code of Civil Procedure, Order XXX, actions may be brought by or against partners in the name of the firm and even between the firm and their members but that is only a matter of procedure. A partnership firm is not a distinct legal entity apart from the partners constituting it, unlike the Scottish system of law where the firm is a legal person distinct from the partners comprising it—*Malabar Fisheries Co. v. CIT* [1979] [120 ITR 49](#) (SC) and *CIT v. R.M. Chidambaram Pillai* [1977] [106 ITR 292](#) (SC). However, for certain purposes some degree of personality is attached to the firm, e.g., it can acquire and own property for the purposes of its business either by regular purchase or by contribution by partners. During the subsistence of partnership no partner can deal with any portion of the property as his own, not even to the extent of his share in the partnership. Thus the abstract proposition that partnership is not a legal entity is not correct. Under the Indian Income-tax Act, 1961, the firm and the partners are distinct assessable entities. The law has for some specific purposes relaxed the general rigid notions, and extended the limited personality to a firm—*D. Kanniah Pillai v. CIT* [1976] [104 ITR 520](#) (Mad.) and *CIT v. R. Rangaswamy Naidu* [1997] [224 ITR 113](#) (Mad.). The firm is treated as an entity only for certain purposes, though it is not a separate juristic entity distinct from its partners and cannot be equated to a corporate body—*Third ITO v. Arunagiri Chettiar* [1996] [220 ITR 232](#) (SC). Such entity is treated as body corporate for tax purposes and deemed company on the terms of article 3(1)(b).

Definition - Other body of persons

9.14 The third category of person, besides individual and a company, is "any other body of persons". A body of persons which is not a company or deemed to be a company, is also a person in terms of article 3(1)(a). Structures or organisations which lack independent legal capacity constitute "other body of person" such as, association of persons, body of individuals, fund, foundation, trust, or a club. It is treated as person.

Definition - Association of persons

9.14-1 An association of persons (AOP) means an association in which two or more persons join in a common purpose or common action, the object of which is to produce income, profits or gains—*N.V. Shanmugham & Co. v. CIT* [1971] [81 ITR 310](#) (SC). An element of joint venture for profit is necessary to constitute an AOP—*CAIT v. Raja Ratan Gopal* [1966] 59 ITR 728 (SC). Volition on the part of its members is an essential ingredient—*G. Murugesan & Bros. v. CIT* [1973] [88 ITR 432](#) (SC). Coming together or combining is a consensual act. Such a combination may not be a consequence of a contract. The association need not necessarily be on the basis of a contract like a partnership. But when persons combine for producing income, it should be assumed that it was a consensual act on their part and the result of understanding between them—*Mohamed Noorullah v. CIT* [1961] [42 ITR 115](#) (SC) and *CIT v. N.V. Shanmugam & Co.* [1966] [62 ITR 701](#) (Mad.). Thus, in order to constitute an AOP, they must join in common purpose or common action and the object of the association must be to produce income—*Sardar Harvinder Singh v. ACIT* [1997] [227 ITR 512](#) (Gau.). Co-sharers of an estate—*CAIT v. Raja Ratan Gopal* [1966] 59 ITR 728 (SC), widows succeeding to the estate of the deceased—*CIT v. Indira Balkrishna* [1960] [39 ITR 546](#) (SC), shareholders jointly receiving dividends from shares—*G. Murugesan & Bros. v. CIT* [1973] [88 ITR 432](#) (SC), do not constitute AOP as they do not form a unit for the promotion of any joint enterprise to earn income, profits or gains. Collection of income from the estate by one of the sharers or even by a common employee does not make that income from a joint venture. Each gets his income as an individual. But the business carried on by joint receivers on behalf of co-heirs—*Mohamed Noorullah v. CIT* [1961] [42 ITR 115](#) (SC), or a firm's business, by receivers on behalf of the partners of the dissolved firm - *N.V. Shanmugham & Co. v. CIT* [1971] [81 ITR 310](#) (SC) and *CIT v. Duduwala & Co.* [1986] [160 ITR 170](#) (Raj.), or a business, by a group on joint

basis—*CIT v. Buldana Distt. Main Cloth Importers Group* [1961] [42 ITR 172](#) (SC) and also *CIT v. Vyas & Dhotiwala* [1959] [35 ITR 55](#) (SC), are illustrative examples of such business being carried on by an AOP. Every combination does not make an AOP. The combination may be association of corporate bodies, or of a firm and an individual or a group of individuals. Joining together in a common venture with the object of producing income is the criterion.

Definition - Body of individuals

9.14-2 There is another association, known as body of individuals (BOI). It is somewhat similar to AOP, but not identical. AOP may consist of non-individuals. BOI consists of only human beings. The expression "body of individuals" must receive a wider interpretation than the "association of persons", perhaps not wide enough to include a combination of individuals who merely receive income jointly without anything further as in the case of co-heirs inheriting shares or securities, but certainly wide enough to include a combination of individuals who have unity of interest but who are not actuated by a common design and one or more of whose members produce or help to produce income for the benefit of all - *CIT v. Modu Timblo (Individual)* [1994] [206 ITR 647](#) (Bom.). "Body" in BOI would mean association for some common purpose or object and there must be unity under some common tie or occupation. A mere collection of individuals without a common tie or aim will not constitute BOI. A BOI must be capable of holding income producing asset or asset that produces income.

Definition - Funds, foundations, trust etc. person

9.14-3 A group of persons having common interest of any kind carrying on an economic activity and constituting a unit commonly recognised having a separate and distinct existence in the community, empowered by law or custom to own property or transact business, but having neither independent legal capacity nor independently taxable entity can constitute "other body of persons", such as a trust, a fund, or a club etc. A trust is a legal obligation established by an individual (the "settlor") binding one or more persons (the "trustees") to hold and deal with assets (the "trust property") for the benefit of the other persons (the "beneficiaries"). Upon creation of the trust, the settlor surrenders legal ownership and control over the assets comprised in the trust property. The assets are held by the trustees who have full legal control over them (legal ownership). Legal ownership of the asset is thus separated from the right of their enjoyment and use (beneficial ownership) which usually reside in the beneficiaries. In the legal systems where the trust system is recognised, the courts can compel the trustees to discharge their obligations and thus protects the interest of the beneficiaries. It is simultaneous existence of legal ownership of assets separate from the beneficial ownership. The trust provides convenience, flexibility and often anonymity over the transfer and control of assets. The trustees are assessed to tax in respect to the property or assets held by them for the benefit of others, as a unit, if the beneficiaries are not certain or known or the trust is discretionary. It is a person for treaty purposes. Similarly funds such as investment funds or mutual funds are persons for treaty purposes. If incorporated, they are company; if not, body of persons.

Definition - Investment funds

9.14-4 An investment fund simply means an entity carrying on a systematic and organised business in dealing or holding investments (shares, stocks, debentures or other securities). It has been defined as an entity - see International Fiscal Association, 1997 Edition, New Delhi, Vol. LXXXIIb, Kluwer, p. 36 :—

- a. Whose purpose is to receive income and capital gain resulting from normal stewardship; and
- b. Which is truly open to number of investors, by virtue of accessibility and tradeability of its interest; and
- c. Which is regulated in terms of its transparency of purpose and operation of independence.

Investment fund was historically meant to stimulate savings and equity investment and for the provision for income of future. The investor basic aim is to earn income from investment and capital gains from sale of such investment. Investment is its asset. That asset is the source of income. If an asset is employed by way of investment and produces income, the income arises or springs from the asset. The operation which causes the income is the operation of investment. In such operation, the income is produced while the asset continues to belong to the Fund. In the operation of sale, gain is produced, which is still income, but in the process, the title to the asset is parted with. Although the process involved in the two cases are different, the gain which has resulted to the fund in each case, is the gain which has sprung or arisen from the asset. Capital gain is also income from investment. All this requires expertise and active participation. The exercise has to be undertaken with some care, diligence and skill as a prudent business person does. The purpose or intent of the holder of investment is to undertake an activity involving investment, to hold asset as investment and to generate income as investment income. Investment is the

basic feature. While undertaking the exercise, some risk has to be taken as a prudent businessman would do. The trend is towards shedding passivity in investment decisions. Generation of income is the purpose. It may be done not only by making passive investment to earn by way of interest or dividend, but also from new investment products and scheme. They are not only used to finance or refinance pension schemes and other security systems, but also capitalise new technology ventures and emerging markets and as a means of securing privatisation, sometimes even as a major shareholder. Now the basic philosophy of the investment fund is :—

1. It makes short money long;
2. It provides sharing of risk management and cost effective basis;
3. It provides access to investment expertise.

Fund is an entity between the investor and the investment. It is a company, if incorporated; a body corporate if created by or under the Act of Parliament; or a body of persons, if it is neither. In India, there are four categories of investment funds; investment companies, mutual funds, public provident fund, and, pension fund.

Definition - Investment company

9.14-5 Investment is understood as an expenditure to acquire property or other assets in order to produce revenue, the asset so acquired, the placing of capital or laying out the money in a way intended to secure income or profit from its employment. It is indicated in the Black's Law Dictionary sixth edition, "to purchase securities of a more or less permanent nature, or to place money or property in a business venture or real estate, or otherwise lay it out, so that it may produce revenue or gain (or both) in future. An investment company has been introduced as an issuer which:

1. is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, re-investing, or trading in securities;
2. is engaged or proposes to engage in the business of issuing face-amount certificates of instalment type, or has been engaged in such business and has any such certificates outstanding; or
3. is engaged or proposes to engage in the business of investing, re-investing, owning, holding, or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40 per cent of the value of such issuers' total assets (exclusive of Government securities and cash items) as an unconsolidated basis.

(see Black's Law Dictionary - Sixth edition)

Thus a company or trust uses its capital to invest in other companies. It differs from holding company in that the latter seeks control of the ventures in which it invests, while an investment company seeks the investment for its own sake and normally diversifies its investment. It has been pointed out in the Black's Dictionary that there are two principle types; the closed end, and, the open end, or the mutual fund. Shares in closed end investment companies are readily transferable in the open market and are bought and sold like other schemes. Capitalisation of these companies remains the same unless action is taken to change. Open-end funds, sell their own new shares to investors, stand ready to buy back their old shares, and are not listed. Open funds are so called because their capitalisation is not fixed; they issue more shares as demanded—*CIT v. Emcete & Sons (P.) Ltd.* [1995] [215 ITR 817](#) (Mad.).

Definition - Mutual funds

9.14-6 When a trust collects money by sale of units from the public and invests the same in securities with a view to sharing the profits therefrom, then it is engaged in the business of mutual funds—*Kinetic Engineering Ltd. v. UTI* [1995] 84 Comp. Cas. 811 (CLB). A mutual fund is also called unit trust or open ended trust. It is sponsored to raise money by the trustees through the sale of such units. The expression "unit" means interest of the investors in the mutual fund scheme, which consists of each unit representing one undivided share in the assets of the scheme. In India, the concept started in 1963. A Unit Trust of India Act, 1963 was passed and thereunder a Unit Trust of India (UTI) was created. The UTI has been declared, by section 32(3) of the said Act, to be a company and income distribution by it, "dividends" for the purposes of certain provisions of the Income-tax Act, 1961 such as section 80L (*vide* CBDT Circular No. 567 dated 19th July, 1990 [1990] 184 ITR (St.) 164. The Income-tax Act refers income from units separately from "dividends" at several places and it is also not certain that the units can be said to be shares. The Income-tax Act, accords the same treatment to income from units of the UTI and from mutual funds covered by section 10(23D), (for example sections 80CC, 80L, 88A, 115A). Section 115AB and section

115AC of the Act provide for analogous concessions in respect of units and dividends, respectively (section 80M, since deleted, was an exception).

Definition - Body of persons treaty entitlement to beneficial owners

9.14-7 An organisation may be taxed as such in only one state; in another, its beneficial owners. The treaty protection to the beneficial owners cannot be denied only on the ground that they are not subject to tax in the source state and the right could be claimed only by the organisation if it is taxed as such in another state. That right passes through to the shareholders. Treaty protection applies to them even if they are not resident in the state in which the organisation is taxed as an entity. India/US treaty provides that in case of income derived or paid by a partnership, estate, or trust, the term "resident of a Contracting State" applies only to the extent the income derived by it is subject to tax in that state as the income of the resident, either in its hands or in the hands of its partners or beneficiaries [*see* article 4(1), proviso (b)]. Such interpretation could be relevant even where there is no similar provision.

Definition - Enterprise of a Contracting State

9.15 The expression "enterprise of a Contracting State" has been defined to mean an enterprise carried on by a resident of that State. In common parlance "enterprise" means an economic activity carried on by a person, capable of producing profits. It is an activity which is exercised in an independent manner, consisting of well defined actions, and, having economic character.

It may also mean an organisation of capital and labour with a view to making profits by participating in the market activities. A proprietorship, a partnership, joint venture, trust, corporation, a group of persons having common interest of any kind carrying on economic activity, and constituting a unit commonly recognised as having a distinct existence in the community.

Thus an enterprise may mean an activity and also an organisation. It is further discussed under permanent establishment.

Enterprise and adventure in the nature of trade

9.15-1 The term "enterprise" includes any form of undertaking, whether carried on by an individual, corporation, association of persons or any other entity, resident in a contracting State. A transaction entered into for business or commercial purposes is an enterprise. The activities of passive investment company is an enterprise.

A question arose in Australia whether a Swiss resident constituted an enterprise when it made two purchases of units in a unit trust using borrowed funds, for the purpose of making a profit, which was followed by exchange of the units for shares and the sale of those shares. The High Court said that it was an enterprise. It was done on the ground that the transaction was undertaken for commercial and business purposes—*Thiel v. Commissioner of Taxation* [1990] 90 ATC 4717 (an Australian case). The court held that a single activity may constitute an enterprise.

The Canadian Supreme Court has come to the similar conclusion in relation to an isolated "adventure in the nature of trade", carried on in Canada by the Irish resident while applying the Canada-Ireland Treaty (1955) in which Irish enterprise was defined as "an industrial or commercial enterprise or undertaking carried on by a resident of Ireland". In *Tara Exploration and Development Co. Ltd.* [1972] DTC 6288, Jaccett P. held that, with great doubt about the correctness of his conclusion, although business was defined to include an adventure in the nature of trade, such a business is not carried on which implied repetition. However, even if this were wrong, he held that the "treaty exemption transaction, in spite of treaty requiring that there was an industrial or commercial enterprise carried on by a resident of Ireland".

The Supreme Court decided the case on the basis of the treaty, which implied that they thought the transaction was taxable under the internal law, and had therefore, carried on an adventure in the nature of trade. Thus a person could be engaged in an adventure in the nature of trade without carrying it on. On similar reasoning, if a partnership has been held to exist for an isolated transaction, could it be said carrying on business. For the purpose of a treaty a Jersey partnership was held carrying on a single enterprise—*Padmore v. IRC* [1987] STC 36.

Definition - Terms not defined in the Double Taxation Agreement

9.16 Terms not defined in the Convention have the meaning which they have under the law of that State concerning the taxes to which the Convention applies. The reasons for adopting a reference to internal law is that since two tax treaties relieve from tax, it is necessary for the relieving provisions to follow the definitions used in the taxing provisions, e.g., of the State in which the immovable property is situated or the State of residence of the dividend paying company in case of dividend income. The advantage is that the treaty relief always corresponds to the internal law taxation of the income in question. The whole object is to relieve from double taxation. One has, therefore, to look to those profits of the business which by law of the source or the residence State, as the case may be, are made subject to taxation. Article 3(2) seems to be designed to that very end—*Ostime v. Australian Mutual Provident Society* 38 TC 492.

The text of the paragraph has been amended from the previous model to clarify that if the term is defined in both the tax and non-tax laws of a Contracting State, the definition in the tax law will take precedence over the definition in the non-tax laws.

Section 90 of the Indian Income-tax Act, 1961, provides that any term used but not defined in the Act or in the agreement shall, unless the context otherwise requires, and is not inconsistent with the provisions of the Act or the agreement, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in the behalf (Sub-section (3) of section 90, inserted by the Finance Act, 2003, w.e.f. 1-4-2004).

Definition - Terms not defined - Government

9.16-1 The Authority for Advance Ruling has to consider a question [*DLJMB Mauritius Investment Company v. CIT* [1997] [94 Taxman 218](#) (AAR- New Delhi)] whether Reserve Bank of India and FIPB could be described as Government for the purposes of article 11 of the Indo-Mauritius treaty. The Authority observed (head notes) :

"Though the tax treaty does not define the expression 'Government', under article 3(2), any term not defined therein will, unless the context otherwise requires, have the meaning which it has under the laws in force in India. Both under the Constitution of India and, on general principles, the RBI which is a Government agency completely owned by the Government of India and the FIPB which is only a committee of the Government of India can appropriately be described as 'Government' for the purposes of this clause. If, therefore, a transaction entered into by the assessee is approved by the FIPB or the RBI or by any other governmental body entitled to grant such approval to the terms of that transaction, the interest receivable by the applicant thereunder will be exempt within the meaning of article 11(4) from the Indian income-tax laws in respect of the category of income in the hands of the non-resident."

Definition - Terms not defined - "India"

9.16-2 The term "India" has been defined in section 2(25A) of the Indian Income-tax Act, 1961, which extends taxing jurisdiction of India beyond the territory of India as defined under article 1(3) of the Indian Constitution (territory of States, Union territories specified in the First Schedule; and such other territories as may be acquired) and also beyond its territorial waters which is a part of the territory of India (for further discussion *see* paragraph 40.26). The definition has now been amended by the Finance Act, 2007. The revised definition defines India to mean—

- the territory of India as referred to in article 1 of the Constitution,
- its territorial waters, seabed and subsoil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the Territorial Waters, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act, 1976 (80 of 1976), and
- the air space above its territory and territorial waters.

The definition extends the Indian taxing regime beyond the territory of India and the territorial waters, to seabed and subsoil of its territorial waters, continental shelf, exclusive economic and other maritime zone and air space above its territory and territorial waters. The extension applies to the extent that India exercises sovereignty in accordance with international law for purposes of natural resource exploration and exploitation of such areas. The Government of India issued a notification (GSR No. 304 (E), dated 31 March, 1983 (1983) 142 ITR (St.) 11) to extend the taxing jurisdiction for the following activities—

- (a) the prospecting for or extraction or production of mineral oils in the continental shelf of India or the exclusive economic zone of India;

- (b) the provision of any services or facilities or supply of any ship, aircraft, machinery or plant (whether by way of sale or hire) in connection with any activities referred to in clause (a);
- (c) the rendering of services as an employee of any person engaged in any of the activities referred to in clause (b).

Any activity connected with such natural resource exploration or exploitation would be considered as being carried in the territory of India.

The new definition was necessary for the purpose of taxation of such business activity in the territorial waters, under its seabed, subsoil, continental shelf. For the purpose of off-shore taxation, the continental shelf is expressly included as a part of the territory of the internal tax legislation. The USA did it in 1969 by extending the definition of "USA" in the Internal Revenue Code. Off-shore petroleum related business activity are automatically covered. Various other States defined their country in the revenue code to extend their taxing jurisdiction U.K. in 1973, Germany in 1974.

With the advance of technology and the manner of doing business, many of the business activities are being undertaken through satellites in space. Income arising as a result of business activities performed in space would be taxable in India to the extent the activities have the required connection to the Indian taxing territory. The OECD Commentary on article 7, paragraph 4, has pointed out to new situations as regards the implementation of the double taxation conventions arising out of the business activities in space and also whether making provisions in the Model Convention covering them is desirable or they are met under the existing provisions. It reads as follows :

"There has been, since 1950s, rapid development of activities in space: the launching of rockets and spaceships, the permanent presence of many satellites in space with human crews spending longer and longer periods on board, industrial activities being carried out in space, etc. Since all this could give rise to new situations as regards the implementation of double taxation conventions, would it be desirable to insert in the Model Convention special provisions covering these new situations? Firstly, no country envisages extending its tax sovereignty to activities exercised in space or treating these as activities exercised on its territory. Consequently, space could not be considered as the source of income or profits and hence activities carried out or to be carried out there would not run any risks of double taxation Secondly, if there are double taxation problems, the Model Convention, by giving a ruling of the taxing rights of the State of residence and the State of source of the income, should be sufficient to settle them. The same applies with respect to individuals working on board space stations: it is not necessary to derogate from double taxation conventions, since Articles 15 and 19, as appropriate, are sufficient to determine which Contracting States has the right to tax remuneration and Article 4 should make it possible to determine the residence of the persons concerned, it being understood that any difficulties or doubts can be settled in accordance with the mutual agreement procedure."

Application - Tax treatyApplication - Tax treaty

9.17 Article 3(2) is a general interpretative clause. It applies only when the term has not been defined in an agreement, though used in it. The parameters for its application have been set out by the following expression used therein :

- "In the application of the provisions of the Convention"
- "Unless the context otherwise requires"
- "The law of the State concerning the taxes"

The implications of these expressions are discussed below:

Application - Of the provisions of the ConventionApplication - Of the provisions of the Convention

9.18 Article 3(2) starts with the expression "as regards application to the Convention". Application means to put into operation the Convention. The given meaning should enable the treaty provision to be effective (*see IRC v. Exxon Corp.* [1982] (UK) and *Union Texas, Petroleum Corpn. v. Critchery* [1988] (UK)). It could, therefore, be taken as equivalent to referring to the Convention. The expression "application" conveys determination of tax liability of a person in respect of an income which is likely to be assessed either in the country of his residence or in that where its source situates or in both in accordance with the provisions of the agreement. The person's obligation under the domestic law are abridged by the agreement provisions. The tax authorities or the courts, whenever, a question arises before them relating to tax imposed on the person who is subject to agreement in terms

of the domestic laws, determine such question by making a reference to the provisions of the agreement or in other words, by applying its provisions. Application also means determination whether or not the agreement is applicable or the income which is exempt from tax by any of its provisions. Every question concerning tax, its extent, exemption, or about the person who is liable which requires reference to the agreement or interpretation, is said to have been decided by its application. Articles 1 and 2 use the expression "This Convention applies..." Thus, the application of the agreement relates to the persons who are resident of one or both of the contracting states, irrespective of the manner in which they are levied (article 2). The determination of the residential status of a person or the nature and the extent of the taxes imposed by the contracting states, requires reference to the provisions of the agreement and their interpretation. The determination thus arrived at has been done by the application of the agreement provisions. Domestic laws, therefore, are subject to such agreement provisions.

In fact source State applies the treaty and determines tax liability in respect of income having source therein, according to its domestic law as abridged by the treaty. The residence State is responsible, in terms of article 23, to exempt from tax income or capital which, in accordance with the provisions of the tax treaty, may be taxed in the source State and is, thus, obliged to grant relief notwithstanding its nature under its own law. The Source State is restricted by the provisions of the tax treaty while applying domestic law. In other words, the treaty is applied to limit the application of domestic law. The residence State also applies but in accordance with the law of the Source State. If it is not done, double taxable may result. That is what happened in *Pirre Boulez* case [1984] 83 TC No. 131 (US). Whether payment to Boulez in response to an agreement to conduct certain musical performances and for making phonographic records was to be treated as compensation for personal services or royalties. The German authorities treated as royalties and the US, compensation for personal services. The disagreement led to double taxation.

Application tax treaty - Reference to law of State may mean law at the time of its signing or application

9.19 According to one view reference to domestic laws may be understood as the law prevailing at the time of signing the agreement, and not the law amended from time to time—*The Queen v. Melford Developments, Inc.*, 35D Tax 5020 [1981]; 36D Tax 6281 [1982]. The rights and obligations of the contracting parties got crystallised on the basis of what the law was in operation at the time of signing of the agreement. The double taxation agreement operates on its own terms and articles. The Parliament of a country cannot alter the wording of the double taxation agreement without the consent of the parties to it—*Ostime (Inspector of Taxes) v. Australian Mutual Provident Society* [1960] 39 ITR 210 (HL). The reasons are obvious :

- The aims, objects and intention of the agreement could be well understood in the context of the law prevailing at the time when it was drafted and signed. What the law could be during the period to follow, nobody could have visualised without divine prescience.
- Secondly, interpretation of the agreement according to the amended law tantamounts to allowing the States to alter the scope of their international obligations.
- Thirdly, in view of the terminology used in article 3(2), it should be considered that there was legislation by incorporation of the statutory provisions of the internal income-tax law as understood at the time of signing the agreement and no further changes in the said law could be called in aid for interpreting the terms of the agreement.
- Fourthly, though the Legislature of one country has all the powers to modify, amend or enact a provision and to mandate its operation with retrospective effect, but the area of its jurisdiction cannot extend beyond its territory and the so amended provision cannot have effect on international agreements or treaties, unless the other country consents its operation.

The other view is that reference in paragraph 2 to the domestic law of a Contracting State means the law in effect at the time treaty is being applied, not the law as in effect at the time the treaty was signed.

Both views require a balanced approach. The former view ensures the permanency of commitments entered into at the time of signing of the treaty and the latter, convenient application of the treaty provision. The matter is discussed in the following paragraphs.

Application tax treaty - Reference to law may mean law at the time of construction of the term

9.20 The expression "law of the state" in article 3(2) may mean law in force at the time of construction of a term. That expression is akin to the referential legislation. Broadly speaking such legislation falls into two categories. First, whereby a statute by a specific reference incorporates the provisions of another statute as of the time of adoption. Second, where the statute incorporates by a general reference the law concern in a particular subject as a genus. In the case of the former, the subsequent amendments made in the referred statute cannot automatically be read into the adopting statute: in the latter, it may be presumed that the legislative intent is to include all the subsequent amendments also, made from time to time in the generic law on the subject adopted by general reference—*Bajya v. Smt. Gopikabai* AIR 1978 SC 793. The principle of construction of a reference statute has been neatly summed up by Sutherland. A statute which refers to the law of a subject generally adopts the law on the subject as of the time the law is involved. This will include all amendments and modifications of the law subsequent to the time reference statute was enacted. Reference to domestic law in article 3(2) is referential incorporation and be taken to mean reference to the law as amended from time to time. Certain provisions of the agreement are relevant in the context of the existing laws. For example, the expression "income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is resident" in article 10(3), would be meaningful only if read with reference to the existing laws and not with those at the time of signing of the agreement. But by doing so, the state may render the treaty inoperative by amending afterwards its domestic laws. There should, therefore, be a balance between the two views, as discussed below.

Application of treaty - The prevailing applicable tax laws

9.20A Application of the law as in force when the convention was signed or as when applied was a difficult proposition of interpretation. The OECD Model Convention was amended in 1995, preferring the latter interpretation. The UN Model Convention has also been amended. But the contextual interpretation may require determining the meaning of the contracting States when signing the convention, *i.e.*, an implicit reference to the principle of reciprocity on which the convention was based. The wording of paragraph 2 of the OECD Model Convention "provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided)" (OECD Commentary on Article 3, para 13).

Application tax treaty - Substitutes domestic law categorisation

9.21 Double taxation agreement is a compromise between the two competing tax claims of the contracting States. The compromise is with regard to the substantive law. It means that every time a State reads the treaty it should substitute internal law categorisation of income. Relief from double taxation is the purpose. One must, therefore, look to those profits or surpluses which are subject to taxation by the both contracting States. Reference to the Convention will arise in case of the following categories of income :

- Business profits (articles 5, 7 and 9 of the OECD and the UN Model)
- Professional profits (article 14)
- Employee income (article 15)
- Dividends (article 10)
- Interest (article 11)
- Royalty and similar payments (article 12)
- Capital gains (article 13)
- Other income (article 21).

Under the Indian Income-tax Act, 1961, income is almost similarly classified. The object is to compute income according to classification. The mode of computation is different for each type. This is discussed separately, later.

Application tax treaty - Liability under domestic law is restricted

9.22 The provisions of the treaty apply only insofar as they restrict tax liability under the domestic law. They do not extend the taxing powers of the States, but only restrict tax claims. The treaty does not create charge. Notwithstanding provisions of the treaty, the State cannot make claim if its domestic law does not permit. This relationship between the domestic and the treaty law would mean that the treaty cannot extend jurisdiction, which the State does not have under its domestic laws. For example, when article 12 of the Indian treaty with Sweden allows the source State to gross withholding taxes with respect to technical services supplied by say an Indian enterprise in Sweden, it does not empower the Swedish State to exercise jurisdiction to withhold tax on the gross amount when its domestic law does not so empower. Such income is taxable only if the services are attributable to permanent establishment. It means that gross income is not taxed. The national Swedish law does not allow gross withholding taxes on such payments. If it is found that the Indian enterprise has a permanent establishment in Sweden only then technical services income is taxable at the rates specified in the treaty.

When an income is taxed by the source State in accordance with its domestic law, the residence State has to exempt or give credit for the tax in the source State. The involved two steps are :—

1. First, checking whether the Source State has taxed the income in accordance with treaty. It involves the residence State reading the treaty and not applying it;
2. Second, granting credit or exemption. It involves the residence State doing something which it would not have done apart from the treaty.

Application tax treaty - Applicable law

9.23 The tax treaty is silent about the applicable law. Exceptions are articles 10, 11, and 12 of the UN Model (articles 10 and 11 of the OECD Model). Paragraph 2 thereof provides for limitations to taxes to be levied on dividends, interest and royalty income, and also empowering the competent authorities of the contracting States to settle the mode of application of these limitations, by mutual agreement. The State is free to apply its own laws and levy tax either by way of deductions at source or by individual assessment. Each State, can apply the procedure as prescribed in its laws. It can either forthwith limit its tax on the rates given in the article or tax in full and make a refund. Treaty benefit under these articles is not available even if the recipient of income is a person and a resident in terms of articles 3 and 4, under the following circumstances :-

1. The benefit of dividend, interest, and royalties articles in tax treaty is generally available where the recipient is the beneficial owner of the income. The treaty will not apply if the recipient is an agent or the nominee;
2. The entitlement to the tax credit on dividends may not be available where shareholding has not been acquired for *bona fide* commercial reasons;
3. The benefit of the tax treaty may not be available where the recipient fails to fall within the definition of "person" or "company" because it lacks separate legal personality;
4. The benefit of the treaty may not be available when the recipient of the income or the gains may possess corporate personality but qualify for such comprehensive tax exemption in its home jurisdiction that the Revenue refuses to apply tax relief under the relevant treaty. It is done on the ground that the entity is not a resident for purposes of the treaty as it is not liable to tax" or "subject to tax" in its home jurisdiction. (The matter is discussed in Chapter 7 as regards fiscally transparent entities)

Application tax treaty - Special provisions

9.24 Special provisions articles under Chapter VI also refer to application of treaty. Non-discrimination article (article 24) is directly relevant to the methods of application of a treaty. It is because national of one of the contracting States is to be subjected to any taxation or any requirements connected therewith which is other or more burdensome than the taxation and other requirements to which nationals of the other State is subjected. Mutual agreement procedure article (article 25) provides for resolution of difficulties or doubts arising as to the interpretation or application of the treaty. Exchange of information article (article 26) empowers the contracting States for exchange of information as is necessary for carrying out provisions of the treaty or of the domestic laws of the concerning States.

Application tax treaty - And interpretation

9.25 Interpretation and application of a treaty are two different processes. Interpretation is the process of making the meaning of the treaty clear. It determines the legal character and effects of the treaty. Application is the process

that comes thereafter. It determines the consequences of the interpretation of the treaty in a given case. Application means to put the convention into practical operation.

Application tax treaty - Unless the context so requires
‘Unless the context otherwise requires’

9.26-1 The interpretation of the expression ‘otherwise’ can be explained by reference to the particular context of the agreement provisions. If a definition is provided to an expression, the courts are not free to construe the expression otherwise unless it is so warranted by the use of the expression such as ‘except otherwise provided’ or ‘except if the context otherwise indicates’. *S. Sundaram Pillai v. V. R. Pattabiraman* AIR 1985 SC 582. In the absence of the definition, the authorities and the courts should take the aid of the domestic laws relating to similar taxes as are the subject-matter of the agreement bearing in mind that a word may be used in different senses according to the context and that the authority or the court should select only that meaning which is relevant to the context in which it has to interpret that word. An endeavour has to be made to find out the exact sense in which the word has been used in a particular context. See *CWT v. Officer-in-Charge (Court of Wards) Paigah* [1976] [105 ITR 133](#) (SC). The expression used in a statute should ordinarily harmonise with the object of the statute and which effectuates its aims and objects which cannot be ignored. See *CIT v. Satellite Engg. Ltd.* [1978] [113 ITR 208](#) (Guj.) and *Gujarat Industrial Development Corpn. v. CIT* [1985] [151 ITR 255](#) (Guj.). The very conception of interpretation connotes that the words have to be construed in the context in which they are used. They derive colour from their context. See *STO v. Byford Ltd.* [1984] 145 ITR 537 (Delhi). A word, like a man, is very often known by the company it keeps and accordingly, a word is very often to be understood in the context and collocation it is used. This rule of interpretation is known as *noscitur a sociis*—*Smt. Sipra Dey v. Ajit Kumar Dey* AIR 1988 Cal. 28. The interpretation of expression ‘otherwise’ can, however, be explained by reference to a particular context—*Baldevji v. CIT* [1985] [156 ITR 776](#) (Mad.).

Unless the context otherwise requires, the words and expressions in the absence of their definition in the agreement are to be understood in the manner as is done under the domestic tax laws. The context may require an interpretation different from what is done according to domestic laws, if such a reference fails to provide a solution to a tax problem.

It is well-established that, in the absence of definition in the statute, the words occurring in a statute will have to be understood with reference to objects of the Act and in the context in which they occur. Consequently definition given for the words in one statute cannot automatically be imported for interpreting the same words in another statute - *CIT v. Buhari Sons (P.) Ltd.* [1983] [144 ITR 12](#) (Mad.). It is not a sound principle of construction to interpret expression used in one Act with reference to their use in another Act. Neither the meaning, nor the definition of the term in one statute affords a guide to the construction of the same term in another statute and the sense in which the term has been understood in the several statutes does not necessarily throw any light on the manner in which the term should be understood generally. On the other hand, it is a sound and indeed a well known principle of construction that meaning of words and expressions used in an Act must take their colour from the context in which they appear—*S. Mohan Lal v. R. Kondiah* AIR 1979 SC 1132. It, is therefore, clear that the words used in a statute must take colour from the objects of the Act—*S. Mohan Lal v. R. Kondiah* AIR 1979 SC 1132. Other aspects to be taken into account are the state of things existing at the time of passing the statute, the background and the objects of the statute—*D.N. Banerji v. P.R. Mukherjee* AIR 1953 SC 58.

Application tax treaty - And law of the state concerning the taxes to which the convention applies
Application tax treaty - And law of the state concerning the taxes to which the convention applies

9.27 Article 3(2) provides that the undefined expressions have the meaning which they have under the law of the state concerning the taxes to which Convention applies. So far as India is concerned, such act is the Indian Income-tax Act, 1961. Domestic laws relating to taxes which are the subject-matter of the agreement (and not the other) govern interpretation of undefined terms and expressions. It means that if a term used in the agreement has a meaning outside the tax laws, that meaning should give way to the meaning as understood under the tax laws. But if it has the meaning only outside the tax laws or under the tax laws other than those relating to taxes covered under the agreement, the rule of article 3(2) has no application. The applicability of the interpretative principles of the domestic tax laws is limited to the terms used in the agreement which have not been defined in the agreement. The bounds of their applicability are further subjected to the context if such context requires ignoring them. Article 3(2) governs only the interpretation of the terms used in the agreement. The words which are not defined, nor done in

the domestic tax laws relating to taxes covered under the agreement must be understood in the context in which these occur. It is well-established that the words occurring in a statute have to be understood with reference to the objects of the Act and in the context in which they occur. Article 3(2) provides a guide to the extent the law of the contracting state is applicable. The word "context" has been defined in Article 3(2) of the Vienna Convention on the Law of Treaties as comprising text, preamble, annexes, agreement or instrument made by one of the parties and accepted by another in connection with the treaty. This paragraph applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (*see* OECD Commentary, article 3, paragraph 12)

Expressions used but not specifically defined in the convention - Meaning - Other expressions not specifically defined

9.28-1 There are some expressions which have been used in the Model Convention or are used in the agreements but have not been defined under the interpretative provisions. While applying the Convention, the Contracting State may use its own domestic definition, if the context does not require an alternative interpretation. That meaning may be ascertained by reference to the meaning the term has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to the term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of article 25 and, in particular, paragraph 3 thereof that establishes the meaning of terms not defined in the Convention should take those agreements into account in interpreting those terms (*see* OECD Commentary, article 3, paragraph 13.1). Such terms may not also be defined in the domestic law, but have acquired "meaning" as ordinarily understood or explained by the 'Courts'. Article 3(2) therefore, refers to "meaning" rather than "definition" under the domestic laws. Some of such terms are dealt with in the following paras. Expressions such as income (real income, fictional income, substance over form), total income, business, profession, computation of income etc. are discussed in detail later.

Undertaking

9.28-1A According to *Webster Dictionary*, 'undertaking' means anything undertaken; any business, work or project, which one engages in or attempts; or an enterprise. Almost the same meaning is given in the *Law Lexicon* by T.P. Mukherjee (3rd edition). In *In re, Sree Yellamma Cotton, Woollen & Silk Mills Co. Ltd.* AIR 1969 Mys. 280. The Mysore High Court considered the meaning of the word 'undertaking' and observed as under:

"... it is not in its real meaning anything which may be described as a tangible piece of property like land, machinery or the equipment; it is in actual effect an activity of man which in commercial or business parlance means an activity engaged in with a view to earn profit. Property, movable or immovable, used in the course of or for the purpose of such business can more accurately be described as the tools of business of undertaking, *i.e.*, things or articles which are necessarily to be used to keep the undertaking going or to assist the carrying on of the activities leading to the earning of profits." (p. 291)

The meaning of the expression 'undertaking' is a going concern as distinct from its assets and liabilities - *Rustom Cavasjee Cooper v. Union of India* AIR 1970 SC 564 and also *Doypack Systems (P.) Ltd. v. Union of India* AIR 1988 SC 782.

Thus, an undertaking is an activity of man which in commercial or business parlance means an activity engaged in with a view to earning profits.

Industrial undertaking

9.28-2 The words 'industrial undertaking' should be interpreted to mean any venture or enterprise which a person undertakes to do and which has relation to some industry or has some industrial consequences. The notion of an undertaking basically means that it has got to be a concrete and tangible venture in the path of industry to make it an industrial undertaking - *CIT v. Textile Machinery Corpn.* [1971] [80 ITR 428](#) (Cal.).

An industrial undertaking, therefore, would normally be, in its ordinary acceptation, some industrial concern or enterprise or adventure which is undertaken to be done by the person concerned. Whether the industrial undertaking means only the physical assets or the human assets involved in it or the principles of organisation which cover it are to a certain extent unrealistic because industrial undertakings cover a complex of ideas both

physical and non-physical and one cannot be chosen at the cost of the other. It is a complex of ideas and methods of practical execution and, therefore, must necessarily involve both tangible and intangible consideration - *CIT v. Textile Machinery Corpn.* [1971] [80 ITR 428](#) (Cal.).

SourceSource

9.28-3 The Legislature in using the word ‘source’ meant, not a legal concept, but something which a practical man would regard as a real source of income - *Rhodesia Metals Ltd. v. Commissioner of Taxes* [1941] 9 ITR (Suppl.) 45 (PC) and *CIT v. Lady Kanchanbai* [1970] [77 ITR 123](#) (SC). Legal concepts must, of course, enter into the question as to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical hard matter of fact. Property is one possible source of income. The work of persons or acts done by persons are other possible sources of income, if a person has rights over property or in relation to property, he may have derived income from that property the source is property or if a person by himself or by his servants or agents does work of some kind or acts in some way he may derive income from that work or act.

A source may, and commonly does, consist of several factors. The character of the source may depend upon which of the factors is dominant. The earnings of a carpenter who owns his tools, or of a taxi driver who owns his car, are treated as wholly derived from personal exertion, although they are, to a certain extent, derived from property. And there are many forms of income which are regarded as wholly derived from property, notwithstanding the fact that an appreciable amount of personal exertion is involved in connection with the property. Where income derived from wages or salary, again the source has several factors. Personal exertion may be involved in negotiating and obtaining the contract of employment, in performing the stipulated services, and in obtaining the payment for them. The source of wages may, therefore, consist of three elements of getting the job, doing it, and getting paid for it. Which of these factors is the most important element of the source in a given case depends upon the facts of that case. Thus, if the source of income consists substantially in the making of contracts, the place where the contracts are made may be regarded the only significant factor. If it consists in first making contracts and then carrying them into effect in circumstances such that both elements are substantial factors in the source, an apportionment must be made—*Maclaine & Co. v. Eccott (Inspector of Taxes)* [1926] AC 424. If the making of the contract is an insignificant factor, and the only substantial element is its performance, the place of performance is the only relevant locus of the source. Thus, the source does not mean the geographical source of income but rather the ‘nature’ of income. A person who neither owns anything in a country nor has he done anything in that country cannot derive income from that country.

PurposePurpose

9.28-4 The word ‘purpose’ means design of effecting something. It does not mean ‘motive’ which is a force which impels a person to adopt a particular course of action. ‘Motive’ is highly subjective in character and can be found mainly from a course of conduct. But the purpose is more apparent and has immediate connection with the result which is brought out. *See Smt. Padmavati Jaykrishna v. CIT* [1975] [101 ITR 153](#) (Guj.). The purpose of a contract or agreement or arrangement must be what it is intended to effect and that intention must be ascertained from its terms. These terms may be oral or written or may have to be inferred from the circumstances but when they have been so ascertained, their purpose must be what they effect. The word ‘purpose’ therefore, is which it is sought to achieve, the end in view. The word ‘effect’ means the end accomplished or achieved—*Newton v. FCT* 11 ATD 422 (PC). If an arrangement has a particular purpose, then that will be its intended effect and if it has a particular effect, then that will be its purpose. The motive of a person, the impelling force for the person to adopt a particular course of action, is not important as the sole and dominant purpose of a transaction, *i.e.*, the design of effecting something to be achieved or accomplished. The overt acts must be looked at to find the effect of a transaction, whether such effect is ‘calculated’ or designed or could be predicted.

‘For the purpose of’‘For the purpose of’

9.28-5 The expression ‘for the purpose of’ has been used frequently in the double taxation avoidance agreements and, therefore, requires discussion as to reveal its true meaning and content. The proposition ‘for’ has many shades of meaning but when used with the active participle of a verb, it means ‘for the purpose of’ and connotes the end with reference to which something is done. The expression ‘activity for profit’ may, therefore, mean that the activity may not result the profit but it must be carried on with the object or earning the profit. Profit-making must be the end to which the activity must be directed or, in other words, the predominant object of the activity must be making of profit. Where an activity is not pervaded by the profit motive it cannot be said to be an activity for profit—*CIT v. Andhra Pradesh Riding Club* [1987] 168 ITR 393 (AP).

‘For the purpose of business’ ‘For the purpose of business’

9.28-6 The Supreme Court in *CIT v. Malayalam Plantations Ltd.* [1964] [53 ITR 140](#) explained as to what would be the import of the words ‘for the purposes of business’. Subba Rao J. surveyed the English as well as Indian decisions in that behalf and drew pointed attention to two English decisions, namely - *Southern (H.M. Inspector of Taxes) v. Borax Consolidated Ltd.* [1942] 10 ITR (Suppl.) 1 (KB) which, according to the learned judge, gives a more liberal meaning to the expression ‘for the purpose of the trade’ so as to include the purpose of protecting the assets of the company carrying on the trade, and also to the opinion of Lord Davey in *Strong & Co. of Romsey Ltd. v. Woodfield (Surveyor of Taxes)* [1906] 5 TC 215 where, over and above another accepted meaning of the words ‘wholly and exclusively laid out for business’, they were held to mean that the disbursement must be made for purposes of earning profits, the test has been expanded to meet diverse situation, namely, whether the expenditure was incurred for removing the obstacles and impediments in the conduct of the business and whether the amount has been paid in his capacity as a businessman or in his personal capacity. A reference was also made to the decision in *IRC v. Anglo Brewing Co. Ltd.* [1925] 12 TC 803, as to the meaning of ‘for the purpose of such business’ which includes for the purpose of keeping the trade going and of making it pay. Subba Rao, J. there-after summed up the position as under:

"The aforesaid discussion leads to the following result: The expression ‘for the purpose of the business’ is wider in scope than the expression ‘for the purpose of earning profits’. Its range is wide: it may take in not only the day to day running of a business but also the rationalization of its administration and modernization of its machinery; it may include measures for the preservation of the business and for the protection of its assets and property from expropriation, coercive process or assertion of hostile title; it may also comprehend payment of statutory dues and taxes imposed as a pre-condition to commence or for carrying on of a business; it may comprehend many other acts incidental to the carrying on of a business. However wide the meaning of the expression may be, its limits are implicit in it. The purpose shall be for the purpose of the business, that is to say, the expenditure incurred shall be for the carrying on of the business and the assessee shall incur it in his capacity as a person carrying on the business. It cannot include sums spent by the assessee as agent of a third party whether the origin of the agency is voluntary or statutory; in that event, he pays the amount on behalf of another and for a purpose unconnected with the business...."

In *CIT v. Birla Cotton Spg. & Wvg. Mills Ltd.* [1971] [82 ITR 166](#) (SC) the assessee-company spent some amounts towards expenses in engaging lawyers and conducting appropriate proceedings before the Investigation Commission for its case relating to the assessment year in question before the court and also in courts where the vires of the statute under which the Commission was constituted were challenged. The question arose as to whether the charges so incurred in connection with the proceedings before the Investigation Commission could be deducted in computing the profits of the business of the assessee. The Supreme Court ruled that the charges were in the nature of expenses incurred for the preservation and protection of the assessee’s business from any process or proceedings which might have resulted in reduction of its income and profits. In any case, the expenditure was incidental to the business and was necessitated or justified by commercial expediency since it was incurred by the assessee in opposing a coercive Government action with the object of saving tax and safeguarding the business and was, therefore, allowable. The Supreme Court observed that the earning of profits and the payment of taxes are not isolated and independent activities of a business since these activities are continuous and take place from year to year during the whole period for which the business continues, and if the assessee takes any steps for reducing its liability to tax which resulted in more funds being left for the purpose of carrying on the business, there is always the possibility of higher profits.

‘In relation to’, ‘pertaining to’ ‘In relation to’, ‘pertaining to’

9.28-7 The expression ‘in relation to’ (so also ‘pertaining to’) is a very broad expression which presupposes another subject-matter. These are words of comprehensiveness which might both have a direct significance as well as indirect insignificance depending on the context—See *State Wakf Board v. Abdul Azeez Sahib* AIR 1968 Mad. 79 following and approving *Netai Charan Bagchi v. Suresh Chandra Paul* [1962] 66 Cal. WN 767, *Shyam Lal v. M. Shyamlal* AIR 1933 All. 649 (FB) and 76 *Corpus Juris Secundum* 621. It has been interpreted to be the words of widest amplitude. See *National Textile Corpn. Ltd. v. Sitaram Mills Ltd.* AIR 1986 SC 1234. In this connection reference be made to 76 *Corpus Juris Secundum* at pp. 620 and 621 where it is stated that the term ‘relate’ is also defined as meaning to bring into association or connection with. It has been clearly mentioned that ‘relating to’ has

been held to be equivalent to or synonymous with as to 'concerning with' and 'pertaining to'. The expression 'pertaining to' is an expression of expansion and not of contraction and not restrictive.

The words 'pertaining to' and 'in relation to' have the same wide meaning and are used interchangeably for among other reason, which may include avoidance of repetition of the same phrase in the same clause or sentence, a method followed in goods drafting. These are used in expansive sense. The expression 'pertaining to' does not mean 'forming part of'—*Swadeshi Mining & Mfg. Co. Ltd. v. Union of India* AIR 1988 SC 782.

'Incident' or 'incidental' 'Incident' or 'incidental'

9.28-8 The ordinary dictionary meaning of the words 'incident' and 'incidental', as given in the *Living Webster Encyclopaedic Dictionary of the English Language* by the English Language Institute of America, Chicago, is to the following effect:

"Incidental: a. Occurring or liable to occur in connection with something else; happening in fortuitous or subordinate conjunction with something else; casual or incidental; liable to happen or naturally appertaining to —n. Something incidental, as a circumstances; pl. incidental items, esp. expenses."

"Incident: n. A distinct occurrence or event; something that occurs casually in connection with something else; and event or matter of accessory or subordinate character; a distinct episode within a story or play; a seemingly minor occurrence likely to touch off more serious consequences, as in international relations."

Liable or apt to happen; naturally appertaining; conjoined or attaching, esp. as subordinate to a principal thing; be falling; falling or striking as of rays of light on a surface."

Legal Glossary of 1970 published by the Official Language (Legislative) Commission, Government of India, Ministry of Law, at page 131, defines 'incidental' to mean 'occurring or likely to occur in fortuitous or subordinate conjunction with something else'.

Attributable

9.28-9 The expression 'attributable to' is not synonymous with the expression 'derived from'. Though both may seemingly mean the same thing the former is wider in import and scope than the latter. Whenever the Legislature intends to give a restricted meaning it uses the expression 'derived from'. The expression 'attributable to' is used whenever extended meaning is intended to be ascribed. The profits and gains from an activity could be said to be attributable to it—if there is a reasonable nexus between such profits and gains and the said activity. If this nexus exists, the receipts from source other than the actual conduct of the aforesaid activity are taken to be the income attributable to it—See *Cambay Electric Supply Industrial Co. Ltd. v. CIT* [1978] [113 ITR 84](#) (SC) and *Khandelwal Ferro Alloys Ltd. v. R.M. Chakravorthy, ITO* [1985] [152 ITR 20](#) (Bom.). The attribution is the cause which leads to the happening of an event. It must be the cause as distinct from being part of the circumstances in or on which the cause operates. If a rope is weak and on that accounts breaks when it is carrying a normal load or a load less than the normal load, the cause of break is not the load but the weakness of the rope. If there is an abnormal load, there are two causes: one the weakness of the rope and the other abnormally heavy load. Cause means a thing or person or circumstance which produces an effect (cause and effect are co-relative terms) or which occasions something. The income may be the effect of or occasioned by some activity, though the direct and effective nexus between the two may be absent. The income could thus be said to be attributable to that source. If instead of being reasonable, the nexus is direct and proximate, the income can be said to have been derived from that source.

Derived

9.28-10 In the *Living Webster Encyclopaedic Dictionary of the English Language* by the English Language Institute of America, Chicago, the word 'derived' given therein has the meaning given below:

"Derive, v.t. derived, deriving [L. Derivare]. To draw or obtain from a source or origin; to take, as a word, from a particular source, form from a root, stem or the like; chem to obtain as one substance or compound, from another. To trace from a source or origin, as a custom or word; declare to come from a particular source; to obtain by reasoning; deduce- v.i. To come from a source; originate."

Derived, a drawn, obtained, or descended from a source."

Thus, the word 'derived' is not a term of art. It demands an enquiry into the genealogy of the item or the product. But the enquiry should stop as soon as the effective source is discovered, and be not extended into another matter,

however, closely connected with effective source in question is - *CIT v. Raja Bahadur Kamakhya Narayan Singh* [1948] [16 ITR 325](#) (PC). The word ‘derived’ connotes obtaining or drawing or receiving from a source. When something is stated to be derived from something else, the latter is a source, while the former is that which follows from that source—*CIT v. Shri Billeswara Charitable Trust* [1984] [145 ITR 29](#) (Mad.). Profits and gains can be said to have been derived from an activity carried on by a person only if the said activity is the immediate and effective source of the said profit or gain. There must be a direct nexus between the activity and the earning of the profit or gain. The income, profit or gain cannot be said to have been derived from an activity merely by reasons of the fact that the said activity may have helped to earn the said income or profit in an indirect or remote manner - *Mrs. Bacha F. Guzdar v. CIT* [1955] [27 ITR 1](#) (SC), *Cochin Co. v. CIT* [1978] [114 ITR 822](#) (Ker.) and *Gwalior Rayon Silk Mfg. (Wvg.) Co. Ltd. v. CIT* [1983] [143 ITR 590](#) (MP). The expression ‘derived’ cannot be accepted as equivalent to ‘referable to’—*Hindustan Lever Ltd. v. CIT* [1980] 121 ITR 951 (Bom.).

InvestmentInvestment

9.28-11 An investment is an asset held by an enterprise for the accretion of wealth through distribution, such as interest, royalties, dividends and rentals, for capital appreciation or for other benefits to the investing enterprise such as those obtained through trading relationships. Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operation, such as insurance companies and banks. Some hold investments as a store of surplus funds; while some other hold trade investments in order to cement trading relationship or establishing a trading advantage. Investments are held primarily to protect, facilitate or further existing business or trading relations often called trade investments, are not made with the intention that they will be available as additional cash resources, and thus classified as short term. Other investments, such as investment in properties are intended to be held to generate income and capital gain. They are, therefore, classified long term even though they are marketable.

There can be no doubt that in its most comprehensive sense, the word ‘investment’ is generally understood as signifying the laying out of money in such a manner that it may produce revenue whether the particular method be a loan or the purchase of stocks, notes, securities or other property. In popular sense, the word ‘investment’ must be understood as to mean conversion of money into some specie of property from which income or gain is expected to be received—*CIT v. Aloo Investment Co. (P.) Ltd.* [1980] [123 ITR 132](#) (Bom.). So long as the act of investment brings into existence a specie of property, it would be an investment within the ordinary or commercial parlance—*CIT v. Mother India Fire & General Insurance Co. Ltd.* [1980] [123 ITR 477](#) (Mad.).

NotwithstandingNotwithstanding

9.28-12 The expression ‘notwithstanding’ is potent and it could mean only ‘despite’, ‘in spite of’ and ‘nevertheless’ - *Khaizar Basha v. Indian Airlines Corpn.* AIR 1984 Mad. 379. A clause beginning with the expression ‘notwithstanding anything contained in this Act and in some particular provisions in the Act or in some particular Act or in any law for the time being in force or in any contract’, is more often than not appended to a section in the beginning with a view to giving the enacting part of the section in the case of conflict an overriding effect over the provisions of the Act or the contract mentioned in the *non obstante* clause or any contract or document mentioned in the enactment following it will have its full operation or that the provisions embraced in the *non obstante* clause would not be an impediment for an operation of the enactment—*South India Corpn. (P.) Ltd. v. Secy. Board of Revenue* AIR 1964 SC 207 and *Chandavarkar Sita Ratna Rao v. Ashalata S. Gwam* AIR 1987 SC 117.

The Supreme Court in *Chandavarkar Sita Ratna Rao v. Ashalata S. Gwam* AIR 1967 SC 117 held that the expression ‘notwithstanding’ is in contradistinction to the phrase ‘subject to’, the latter conveying the idea of a provision yielding place to another provision or other provisions to which it is made subject.

It is well known that a *non obstante* clause is a legislative device which is usually employed to give overriding effect to certain provisions over some contrary provisions that may be found either in the same enactment or some other enactment that is to say to avoid the operation and effect of all contrary provisions - *Union of India v. G.M. Kokil* AIR 1984 SC 1022.

When two or more laws operate in the same field and each contains a *non obstante* clause stating that its provisions will override those of any other laws stimulating and incisive problems of interpretation arise. Since statutory interpretation has no conventional protocol cases of such conflict have to be decided in reference to the object and purpose of the laws under consideration. For resolving such *inter se* conflict, one test may be applied though the

persuasive force of such a test is but one of the factors which combine to give a fair meaning to the language of the law. That test is that the later enactment must prevail over the earlier one—*Sarwan Singh v. Kasturi Lal* AIR 1977 SC 265.

OtherwiseOtherwise

9.28-13 The expression ‘otherwise’ occurring in a combination of words sometimes being regarded as indicating the application of *ejusdem generis* rule. For instance, the expression ‘contract or otherwise’ occurring in section 10 of the Estate Duty Act, 1953 was interpreted by the courts to mean either a sale or something akin to sale—see *Attorney-General v. Seccombe* [1911] 2 KB 688 and *George Da Costa v. CED* [1967] [63 ITR 497](#) (SC). The interpretation of the expression ‘otherwise’ can, however, be explained by reference to particular context—*Baldevji v. CIT* [1985] [156 ITR 776](#) (Mad.).

Subject toSubject to

9.28-14 The expression ‘subject to’ was a matter of discussion before the Supreme Court in *South India Corpn. (P) Ltd. v. Secretary Board of Revenue* AIR 1964 SC 207. The learned judges held that the expression ‘subject to’ conveys the idea of a provision yielding place to another provision or other provision to which it is made subject. The Supreme Court in *K.R.C.S. Bala Krishna Chetty & Sons & Co. v. State of Madras* [1961] 12 STC 114 held that the case of the words ‘subject to’ has reference to effectuating the intention of the law and the correct meaning is ‘conditional upon’. The provisions of section 5 of the Madras General Sales Tax Act, 1939, which contained the expression ‘subject to such restrictions and conditions’ were the subject-matter of discussion before the Supreme Court. The appellants in the case were found contravening the provisions of the rules and they could not be said to have observed the conditions upon which the exemptions under the licence was available. It was contended before the Supreme Court that the words ‘subject to’ do not mean ‘conditional upon’ but ‘liable to the rules and the provisions’ of the Act. The Supreme Court did not agree with this contention and held that on a proper interpretation of the section, it only meant that the exemption under the licence is conditional upon the observance of the conditions prescribed and upon the restrictions which are imposed by and under the Act whether in the rules or the licence itself, that is, a licensee is exempt from assessment as long as it conforms to the conditions upon which licence is given. In view of the Supreme Court decision the expression ‘Subject to any rules made in this behalf’ suggests about the paramountcy of rules and their mandatoriness.

Having regard toHaving regard to

9.28-15 The expression ‘having regard to’ means that all relevant factors should be taken into account and considered before a decision is taken. It means a duty—*Union of India v. Hindustan Aluminium Corpn. Ltd.* AIR 1983 Cal. 307. In *Ryots of Garabandho v. Zamindar of Parlakimedi* AIR 1943 PC 164. The Privy Council observed that the expression ‘having regard to’ only obliged the Government to consider all relevant materials to which it must have regard. The Privy Council in another case—*Ishak v. Thowfect* [1968] 1 WLR 1718 observed that the requirement that the Board shall ‘have regard to’ certain matters tends in itself to show that the Board’s duty in respect of these matters is limited to having regard to such matters. They must have an ultimate discretion and are not bound to select a person or persons whom they consider unsuitable.

The Supreme Court had occasion to consider the expression ‘having regard to’ in *Saraswati Industrial Syndicate Ltd. v. Union of India* AIR 1975 SC 460. Under clause 7(2) of the Sugar Control Order passed under section 3 of the Essential Commodities Act, the Government is required to fix the price ‘having regard to the estimated cost of production of sugar on the basis of the relevant schedule’. In interpreting the term ‘having regard to’, the Supreme Court relied upon the interpretation given to the expression by the Privy Council in *Ryots of Garabandho v. Zamindar of Parlakimedi* AIR 1943 PC 164.

IncludesIncludes

9.28-16 It is well-settled that the word ‘includes’ is often used in interpretation clause in order to enlarge the meaning of the words or phrases occurring in the body of the statute and that when it is so used, these words and phrases must be construed as comprehending not only such things as they signify according to their nature and import but also things which the interpretation clause declares that they shall include. When such definition expressly includes things which are not covered within the ordinary meaning of the word, it is clear that the intention of the Legislature was to give a wide meaning to that word itself apart from the definition—*CIT v. Taj Mahal Hotel* [1971] [82 ITR 44](#) (SC). The words used in an inclusive definition denote extension and they cannot

be treated as restricted in any sense. When inclusive definition is dealt with, it would be inappropriate to put a restrictive interpretation upon terms of wider denomination. The word "includes" in an inclusive definition expands the meaning—*Corporation of the City of Nagpur v. Its Employees* AIR 1960 SC 675, *Vasudev Ramchandra Shelat v. Pranlal Jayanand Thaker* AIR 1974 SC 1728 and *Doypack Systems (P.) Ltd. v. Union of India* AIR 1988 SC 782. An inclusive definition is a specie of fiction and its is well-settled that the only limitation on the power of the Legislature to create a fiction is that it should not transcend its power by its creation—*Chandrana & Co. v. State of Mysore* AIR 1972 SC 217, 221.

MeansMeans

9.28-17 Where an interpretation clause defines a word to mean a particular thing, the definition is explanatory and *prima facie* restrictive; and whenever an interpretation clause defines a term to include something, the definition is extensive. Craies on Statute Law, Seventh Edition, page 213. While an explanatory and restrictive definition confines the meaning of the word defined to what is stated in the interpretation clause. So that wherever the word defined is used in the particular statute in which that interpretation clause occurs, it will bear only that meaning unless where, as is usually provided, the subject or context otherwise requires, an extensive definition expands or extends the meaning of the word defined to include within it what would otherwise not have been comprehended in it when the word defined is used in its ordinary sense—*Central Inland Water Transport Corpn. Ltd. v. Brojo Nath Ganguly* AIR 1986 SC 1571.

WithinWithin

9.28-18 The word 'within' means on or before—*Satyavatamma v. Padmavatamma* AIR 1957 AP 30. Where something is to be done within a stated time 'before' a stated date, that means that it is to be done at some time during the course of the stated time, immediately preceding the stated date. The Bombay High Court in *CIT v. Ekbal & Co.* [1945] [13 ITR 154](#) observed that whereas 'within thirty days' is within two points of time: 'one at which the period begins and the other at which it expires', not less than 'thirty days' is outside the two periods. Wren and Martin in *English Grammer* made a distinction between the two propositions 'in' and 'within' thus: 'in' before a noun denoting a period of time, means 'at the end of', and 'within' means 'before the end of'.

'And' and 'or' 'And' and 'or'

9.28-19 In ordinary usage 'and' is conjunctive and 'or' is disjunctive, but to carry out the intention of the Legislature it is sometimes possible to take 'and' for 'or' and *vice versa*. But such occasions should be rare and should only be to avoid absurd consequences that would follow if the words are taken in their liberal meaning—*Mazagaon Dock Ltd. v. CIT* [1958] [34 ITR 368](#) (SC) and *CIT v. Puthuthotam Estates (1943) Ltd.* [1981] [127 ITR 481](#) (Mad.). The Supreme Court in *Manmohan Das Shah v. Bishun Das* AIR 1967 SC 643 and *Tilkayat Shri Govindlalji Maharaj v. State of Rajasthan* AIR 1963 SC 1638. Interpreted word 'or' as 'and'. The Supreme Court in *Ranchhoddas Atmaram v. Union of India* [1961] 3 SCR 718 held that the word 'or' is construed as either. The Supreme Court was considering the provision of the Sea Customs Act, 1878 regarding the imposition of penalty. The learned judges, while upholding the validity of imposition of penalty, observed that it was open to the customs authorities to impose any of the alternative penalties and that on the plain language of the provisions which was in the affirmative from and did not contain negative or prohibitive provision it gave an option to the customs authorities to impose any of the two penalties.

'Where', 'when', 'if', etc. 'Where', 'when', 'if', etc.

9.28-20 The word 'where' is commonly used to introduce the cases of circumstances in which the law is to be applied. The word 'when' is used when a single or rare occurrence of the event is contemplated. 'If', however, is very often a better word because it is the word generally used to introduce a condition in ordinary everyday usage. The expression 'etc.' does not share the character of an inclusive definition and cannot, therefore, enlarge the scope of the expression along with it is used—see *K.V. Mathew v. Distt. Manager, Telephones* AIR 1984 Ker. 40.

DOUBLE TAXATION AGREEMENT - RESIDENT

ARTICLE 4 RESIDENT

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State any political sub-division or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect of only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows :

- (a) He shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
- (b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
- (c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national ;
- (d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the States in which its place of effective management is situated.

IntroductionIntroduction

10.1 Article 1 of a tax treaty applies to a person who is resident of one or both of the Contracting States. Relief under the treaty is available to a "person" who is "resident" of a Contracting State. Article 3 defines the term "person", and article 4, "resident". An entity which qualifies as person in terms of article 3 would not be entitled to the benefit unless it also qualifies to be resident in term of article 4.

Treaty benefit would be available if a person is resident in terms of article 4. But where a treaty contains a Limitation on Benefits provision as in the Indo-US treaty, the person must additionally qualify for benefits under that provision also.

This Article sets forth rules for determination whether a person is a resident of a Contracting state for purposes of the treaty. The determination looks for first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. If a person is resident in both the contracting States, the Article proceeds to assign a single State of residence to him for purposes of the treaty through the use of tie-breaker rules.

That article starts from the simple proposition that a taxpayer is resident in a State for the purpose of the treaty if he is liable to tax because of some specified criteria, under the domestic law of that State (paragraph 1). It, however, goes beyond by including "tie-breaker" provision to resolve cases where under the simple proposition an individual would possess dual residence (paragraph 2). As for persons other than individual, situation of the effective management decides the matter (paragraph 3). The contracting States may, however, settle the criteria by mutual agreement. They may agree upon the place of incorporation in case of companies, or upon location of "head or main office", or registered office, or any other as the criteria. Paragraph 1 of the article fixes the residential status of the person if he is liable to tax under the domestic law of the concerned state by reason of his domicile, residence, place of management or any other criterion of similar nature. On that basis the said person may qualify simultaneously to be resident of both the contracting states. The duality would make difficult the determination of the jurisdiction. Each state would press its claim. The consequence would be opposite to what the tax treaty aims to

achieve, *viz.*, avoidance of taxing the same person for the same income doubly. It is therefore, necessary to assign that status to only one state. Hence, the tie breaking rule. Paragraph 2 is the rule with respect to individual, and paragraph 3, with respect to the person other than the individual.

Resident - UN Model and the OECD Model

10.2 The "Resident" definition article in the UN Model and the OECD Model is similarly worded.

"Resident of a Contracting State" - Functions

10.2A The concept of "resident of a Contracting State" has the following functions:

- it determines scope of application of personal scope of a treaty ;
- determines application of personal scope;
- resolves conflict between two residences ;
- resolves conflict between residence and source or situs.

The personal scope is determined in the light of article 4 which determines the residence of a person to whom the Convention applies. A conflict may, however, arise because of double residence. As a consequence of their domestic laws, both the Contracting States may claim him resident. Article 4 attempts to resolve by providing a tie-breaking rule. It also provides for the resolution of another conflict between residence and source or situs.

Resident of a State - Fiscal residence

10.2B The concept of "Fiscal residence" of a person is of much importance under the domestic law and not for the application of the double taxation agreement. "Fiscal residence" is a place where a person amongst others a corporation is subject to unlimited fiscal liability and subjected to taxation for the world wide profit. In the case of a company, it has two status; corporate status, and, fiscal status. The corporate status is determined under the law of the State of incorporation whereas the tax status is determined under the law of the countries where it carries on its business activities. If income arises in a State, it is taxable by it whether the person is resident or non-resident. The taxable status of a person with reference to State is determined by the fact of arising of income in that State. All States follow the principle of worldwide taxation, in case of a resident and define the term "residence" in their respective tax laws. That definition is based on taxpayer's personal attachment to the State. The full tax liability is not imposed only on persons who are domiciled in a State but also on those who stay continually or for a certain period in the territory of State (*see* OECD Commentary, article 4, paragraph 3). For example, section 6 of the Indian Income-tax Act, 1961, defines the term "residence in India" for the purposes that Act. If a person is resident in terms of that definition, India is the State of residence and has jurisdiction to levy unlimited fiscal liability and the person is subjected to taxation for the worldwide profit. The fiscal residence of the person is India. In the case of a company several factors render determination difficult, namely, place of incorporation, place or places where directors and managers meet and take a decision, place(s) where the business activities are carried, shareholders who control it, etc. Where all elements exist in the same country, there is no difficulty; but where scattered in different, each country may want to subject the company to taxation on the basis of the element present there. Depending on the criterion adopted, fiscal residence shall abide in one or the other country or in both.

Double taxation agreements are not concerned with the domestic laws of the Contracting States laying down conditions for imposing full tax liability on a person, but with the avoidance of double taxation if a person qualifies to be resident of both according to the respective criteria and thus becomes taxable in each. For the application of the double taxation agreement, it is necessary that a person has to be resident of either. It therefore, prescribes rules to determine which of the two concepts of residence is to be given preference (*see* OECD Commentary, article 4, paragraph 5). The Commentary illustrates by an example. An individual has his permanent home in State A, where his wife and children live. He has had a stay of more than six months in State B and according to the legislation of the latter State he is, in consequence of the length of the stay, taxed as being resident of that State. Thus, both States claim that he is fully liable to tax (Paragraph 6 of the Commentary). Paragraph 2 of article 4 of the Model Convention solves the conflicts by giving preference to the claim of State A. It implies only that in the case of conflict a choice must necessarily be made between the two claims. For that purpose that article proposes special rules (*see* OECD Commentary, article 4, paragraph 7) and not for the purpose of determining whether a person is "resident" of this or that State. This is also clear by reading paragraph 1 of article 4 which defines the term "resident of a Contracting State" to mean a person who is liable to tax "under the laws of that State". What criteria the State lays down for purpose determining the tax liability is not the concern of the treaty, whether the person is

considered resident by reason of domicile, residence, place of management or any other similar criteria. He may be resident of both the States, but for treaty purposes would be considered to be of the State whose claim is stronger in terms of rules laid down in paragraphs 2 and 3 of article 4.

Resident of a Contracting State - Criteria for determination

10.3 The concept of "resident" is important as it regulates the mode of taxation of various categories of persons who have sources of income or income earning activities in both contracting states. Paragraph 1 of article 4 defines "resident of a contracting State" to mean any person who, under the laws of that state, is

1. liable to tax therein by reason of
2. domicile, residence, place of management or
3. any other criterion of a similar nature.

Thus, the paragraph contemplates that the liability to tax should arise out of some connection between the person and the state. The three words "domicile", "residence", "place of management" and the expression "any other criterion of a similar nature" have been used only to indicate the need for the existence of some nexus between the person and the state which can justify imposition by it the tax on the income sought to be taxed. Paragraph 1 intends to establish a physical connection. By virtue of that connection a person may be resident of both the contracting states. Such a possibility will render the application of the treaty difficult. For proper assignment of jurisdiction, the person has to be assigned residential status to either of the states. For that purpose paragraphs 2 and 3 have to be referred. All the paragraphs of article 4 have to be read together.

Resident of Contracting State and Resident of a State

10.3-1 The expression "resident" has been defined in article 4, in terms of "resident in a Contracting State" which expression has been defined elaborately. Wherever the word "resident" appears in the DTA, it would be taken to mean "resident of a Contracting State" unless the context otherwise requires.

Resident - Article 4 has to be read as a whole

10.4 The structure of the tax treaty is that it is a more a tax avoidance agreement than a tax relief agreement. Many of its articles are so structured as to ensure that income arising to a person out of the activities in both states is taxed in one or the other state and not in both (*see* articles 6, 7, 8, 13, 15, 18, 19, 22). It is only in regard to an investment such as dividends, interest or royalties (articles 10, 11 and 12) that while, the general practice of having them taxed in both countries, the rate of tax in the source country is pegged at a low figure so as to attract more capital in the country of investment. Paragraph 1 fixes the residential status on the basis of the criteria such as domicile, residence, place of management as laid down under the domestic laws of the state to fasten the tax liability on the person. That liability is also dependent on the location of the source of income in that state. Subsequent paragraphs are the tie breaking rules in a case when a person is liable to tax in respect of the same income in both the states as he qualifies for that status according to the domestic laws. The fact that a person can be termed "resident" in both the states under paragraph 1, far from rendering the application of the treaty difficult or infructuous, usually activates the provisions of paragraph 2 or 3. The duality has to be resolved. The agreement requires a status to be assigned to him as a resident of one of them. Paragraphs 2 and 3 proceed to set out the course to be adopted for the exact situation where a person becomes resident. They lay down the rules to assign residence to one of the states for the purpose of the treaty. Only such a resident can claim relief. In case of a person who is individual, matter is resolved in accordance with clauses (a) to (d) of paragraph 2; and in case of a person other than an individual, in accordance with paragraph 3. If a person is deemed resident by virtue of such criteria, he would not be treated resident of another State though he qualifies for such status in terms of the domestic laws. The Supreme Court of India in case of *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#) (SC) held :-

"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 (Indian Income-tax Act, 1961), 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."

Person liable to tax

10.5 Treaty benefits are to be afforded to persons who are resident in either of the contracting states. The wording of residency article, as discussed, requires a person to be liable to tax in the other contracting state by virtue of a series of connecting criteria. The expression "resident" is employed as a term of limitation; otherwise a person who is not liable to tax in a contracting State.

The expression "liable to tax" does not connote the existence of an actual taxation measure in the state under which the person is factually charged to tax in that state. It connotes a liable person to be subjected to tax by the taxation laws of that state because of any of the said four nexus viz. domicile, residence, place of management or any other similar criterion. Had the factual charge been intended, the article would have used the words "a person who is subjected to tax in that state" or stopped with the words "liable to tax in that state under the laws of that state". Further words in the paragraph would then be pure surplusage. The expression "resident" is employed as a term of limitation; otherwise a person who may not be "liable to tax" in a Contracting State by reason of domicile, residence, place of management etc. may also take the benefit of DTA. Since the purpose of DTA is to eliminate double taxation, the treaty takes into account persons who are liable to taxation and not to others [see *UOI v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) (SC)].

The "liable to tax" test does not require actual taxation but merely presence of characteristics which would entitle a person to treaty benefit. There is a distinction between "liable to tax" and "subject to tax". Article 4(1) refers to the first concept. Before a person is subject to tax, it has first to be determined whether he is liable because of his connecting characteristics with the taxing state. If he is not so liable, he is not subject to tax. If he is liable, then the tax is determined. A person may be liable but not subject to tax by reasons of special provisions in the domestic legislation.

In *Mohsinally Alimohammed Rafik, In re* [AAR No. 206 of 1994, decided on the 23rd December, 1994, [1995] [213 ITR 317](#) (AAR)], the Authority for Advance Ruling observed:

"...an individual like the applicant, though at present not actually liable to pay any income-tax in Dubai, should also be concerned resident of Dubai for the purpose of DTAA as, being a person living in Dubai and having sources of income there, he is certainly liable to be called upon to pay income-tax under the tax laws of that country."

A person who is not liable to tax in the country in which his residence or its seat is located, because it has no income or property or because it is exempt from tax can nevertheless be "resident" there and thus be entitled to treaty protection.

While holding above, the Authority for Advance Ruling gave the following reasons:—

1. Reference to article 4(1) to a person who, under the law of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation or place of management or any other criterion of a similar nature would connote not the existence of an actual taxation measures in the State under which the person in question is factually charged to tax in that State but would connote a person who was liable to be subjected to tax by the taxation laws of that State because of the nexus existing between him and the State, of one of the kinds mentioned in the article. The mention in the article of the four kinds of nexus reinforced this interpretation. For, if the relevant criterion was only to be whether the person in question was actually subjected to tax in the State or not, the article would have used the words 'a person who is subjected to tax in that State' or stopped with the words 'liable to tax in that State under the laws of that State'. The further words in the paragraph would then be pure surplusage;
2. Secondly, several articles in the DTAA which specifically concern individuals would make no sense at all, if individuals living in the UAE were treated as excluded from the benefits of the agreement because they were not currently subjected to any in the UAE tax;
3. Thirdly, if one accepted the stricter interpretation, all corporate bodies would be residents entitled to the benefits of the agreement, they being liable to tax under the Dubai Ordinance, although those provisions are not actually enforced against several categories of companies. In other words, even companies which were not called upon to pay any tax in Dubai would be entitled to claim benefits under the agreement. If this was so, logically there was no reason why individuals should not also be permitted to avail themselves of the benefits of the agreement for the reason that they were not actually subject to tax in Dubai;

4. Fourthly, the structure of the agreement also indicated that it was more a tax avoidance agreement than a tax relief agreement. Many of the articles were so structured as to ensure that the income arising to a person out of the activities in both the States were taxed in one or the other State but not in both. It was only in regard to items like dividends, interest and royalty that while the general practice of having them taxed in both countries was retained, the rate of tax in the source country was pegged at a low figure so as to attract more capital. In this view of the matter, the DTAA clearly voiced the intention that the income of certain types only at a concessional rate in its country of source.

The Authority then observed as follows:—

"Thus, the language of the paragraph 1 of article 4 lent itself to two equally plausible interpretations. One of them seemed to give effect to the natural meaning of some of the words employed in the paragraph. However, it not only resulted in certain other words becoming an unnecessary surplusage but also rendered the agreement practically devoid of all contemporary relevance. On that interpretation, only companies would take advantage of the agreement and all other categories of assessee would be excluded from the benefits for the present. The second interpretation perhaps placed some strain on some of the words but gave meaning to all the words employed, fully accorded with the intention of the objective of the agreement and gave immediate effect to all its terms. In this situation, the authority was of the opinion that the second interpretation was the preferable one and that an individual like the applicant though, at present not actually liable to pay any income-tax in Dubai, should also be considered to be a resident of Dubai for the purpose of DTAA as being a person living in Dubai and having sources of income there, he was certainly liable to be called upon to pay income-tax under the tax laws of that country."

A contrary ruling was given by the Authority for Advance Ruling in *Cyril Eugene Pereira v. CIT* AAR No. 385 of 1997, dated 19th May, 1999, [1999] [105 Taxman 273](#) (AAR), [1999] 154 CTR (AAR) 281, holding that a person who has not been subjected to tax and thus has no liability to pay tax in a contracting State will not be resident of that state and thus entitled to relief under the treaty. There could be serious doubts about many of the observations and also about the process of reasoning by which the conclusion has been arrived at, especially about

- the power of the Central Government under section 90 of the Income-tax Act;
- the object and the purpose of the tax treaty;
- applicable interpretative principles;
 - taxation of dividends by the source State in terms of paragraph 2 of article 10 as meaning, "The tax is something in addition to tax leviable under paragraph 1";
- "If dividend income is taxable under para 1, relief from double taxation of such dividend is provided by para 2 by reducing the rate of tax payable on the dividends. This benefit of a small rate of tax is given in para 2 only because the dividend income has to bear full tax under para 1 which is the primary tax";
 - "The endeavour of article 10 is to grant relief in case of double taxation of dividends. Paragraph 2 presupposes that a tax is leviable under paragraph 1";
- The word "also" in paragraph 2 signifies that besides the first levy in paragraph 1, there may be an additional levy of tax. If there is no liability to pay tax at all in the UAE, paragraph 1 will not be attracted. In such a case there cannot be any question of further tax also in the State in which the company resides."

There are many other observations which are not free from doubt, in the context of a tax treaty. At the moment, matter relates to the expression "liable to tax" in article 4. It was read in the Ruling as to mean "liable to pay tax" or "liability to pay tax". By having so read, the Authority held that "Any entity which does not pay any tax in the UAE will not be a person under the treaty".

The decision was approved with different reasons by the Authority in *Abdul Razak A. Meman, In re* [2005] [276 ITR 306](#) (AAR). Reasons given are :

- that "liable to tax" connoted that a person was subject to tax to one of the taxes mentioned in the article 2 of the Double Taxation Avoidance Agreement in a Contracting State and it is immaterial that whether the person actually paid the tax or not;
- that Article 4(1) postulated the existence of tax liability *in praesenti* by reason of domicile, residence, place of management, place of incorporation or other criteria of a similar nature on the date of making that claim under

the law of the State of which the person is claiming to be a resident;

- that where, however, the tax liability of a person in the concerned State was to arise in the future, the person would become eligible as and when the tax net of the state was so spread as to cover such person.

The Authority read the expression "liable to tax" as meaning "subject to tax" as postulating "existence of tax liability *in praesenti*". It would mean that since an individual is not subject to tax in UAE and there is no tax liability *in praesenti*, he is not a resident of that State and that the benefit of the double taxation agreement would not be available to him, though may be available to a company if the income were earned by it. If that were the intention, the treaty would not have used the words "liable to tax", but would have used some appropriate words like "subject to tax" or "existence of tax liability *in praesenti*". The language of the DTA does not lead to the conclusion that an individual, in order to qualify for the benefit under the DTA, must be subject to tax and there must exist a tax liability *in praesenti*. That perhaps cannot be the intention of the treaty.

It is afraid, such could not be the meaning of the expression "liable to tax" in the context of the tax treaty. The word "liable" may mean "a future possibility or probability of happening which may or may not occur". The meaning as given in earlier Ruling is relevant. The Supreme Court in *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#), also did not approve.

Observing "Having perused the order of the Authority for Advance Ruling (*Cyril's case*), we regret that we are not persuaded." While holding that the Supreme Court did not approve the *Mohsinally Alimohammed Rafik, In re* [1995] [213 ITR 317](#), the Authority in *Cyril's case* relied on the following observations of the Supreme Court (page 742 of 263 ITR) :

"There is substance in the contention of Mr. Salve, learned counsel of one of the appellants, that the expression 'resident' is employed in the DTAC as a term of limitation, for otherwise a person who may not be 'liable to tax' in a Contracting State by reason of domicile, residence, place of management or any other criterion of similar nature may also claim the benefit of the DTAC. Since the purpose of the DTAC is to eliminate double taxation, the treaty takes into account only persons who are 'liable to taxation' in the Contracting States. Consequently, the benefits thereunder are not available to persons who are not liable to taxation and the words "of liable to taxation" are intended to act as the words of limitation."

The above observations of the Supreme Court do not lead to an inference that an individual in order to qualify for the benefit under the DTA must be subject to tax and there must exist tax liability *in praesenti*. These were made in the context that words "liable to tax" are words of limitation that no person other than the person who is resident by reason of domicile or resident etc. could take advantage of. The focus was on such criteria as domicile or residence rather than explaining "liable to tax".

Liability to tax - A jurisdictional legal situation

The Supreme Court in *Azadi Bachao Andolan's case*, observed "Liability to taxation is a legal situation, payment of tax is a fiscal fact". It also observed "The expression used is 'liable to tax thereon' by reasons of various factors", relying on the OECD commentary on article 4, defining resident, which says "Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally 'resident' and, consequently, is fully liable to tax in that State". In *Chong v. Commissioner of Taxation* [2000] FCA 635, the Federal Court pointed out :

"Whether one uses the language of allocation of power or the language of limitation of power, the result is the same; there is designated or agreed who shall have the right under the agreement to impose taxation in the particular area."

Thus, the question of person being subject to or paying tax is not relevant for the determination of the legal status of a person for treaty purpose (which question becomes relevant for determination of the "fiscal status" under the domestic law). What is relevant is whether he is domicile or resident of the concerned State. The use of the words "by reason of" is of much significance because to determine the legal situation (liability to tax) of a person only his other legal status, namely, his domicile (which has reference to civil rights) or residence (which has reference to physical connection to a territory) is to be taken into account. The legal status "liability to tax" is dependent upon ascertaining "domicile" or "residence" status *i.e.*, his physical connection to the territory of or his eligibility to enjoy civil rights in a State and not dependent upon his paying or being subject to tax. The expression "by reason of" would indicate that if and when the tax liability would arise the person would be subject to tax on the basis of

such criteria. In *Asstt. DIT v. Green Emirate Shipping & Travels* [2006] 286 ITR (AT) 60 (Mum.), the Appellate Tribunal observed :

"These tests of fiscal domicile which are given by way of examples following the expression 'liable to tax by reason of' i.e., domicile, residence, place of management, place of incorporation etc. are no more than examples of locality related attachments that attract residence type taxation. Therefore, as long as a person has such locality related attachments which attract residence type taxation, that 'person' is to be treated as resident and this status being a 'resident' of the Contracting State is independent of the actual levy of tax on that person. Viewed in this perspective we are of the considered opinion that 'being liable to tax' in the Contracting State does not necessarily imply that the person should actually be liable to tax in that Contracting State by virtue of an existing legal provision but has the right to tax such person - irrespective of whether or not such a right is exercised by the Contracting State. In our humble understanding, this is the legal position emerging out of the hon'ble Supreme Court's judgment in *Azadi Bachao Andolan's* case [2003] [263 ITR 706](#)."

The Tribunal held that a tax treaty not only prevents "current" but also "potential" double taxation.

The fundamental principle of taxation may be traced in the following observations of *McCulloch v. Maryland*, quoted in *Piedras Negras Broadcasting Co. v. Commissioner* [1941] 43 BTA 297 :

"All subjects over which the sovereign power of a state extends, are, objects of taxation; but those over which it does not extend, are upon the soundest principles, exempt from taxation. This proposition may almost be pronounced self-evident."

Persons who are the objects of taxation are those over which the sovereign power of a State extends, irrespective of whether the tax laws in fact charges them. The sovereign power may extend by reason of an individual person residing within the territory of that state or being domicile thereof. Such a person can be said "liable to tax" and resident of that state for the purpose of the treaty, even though presently not subjected to tax. In *John N. Gladden v. The Queen* [85 DTC 5188 : Canada (FC)] observed :

"...the non-resident can benefit from the exemption (under the treaty) regardless of whether or not he is taxable on that capital gain in his own country. If Canada or the US were to abolish the capital gains completely, while other country did not, a resident of the company which has abolished the capital gains would still be exempt from capital gains in the other country."

Michel Edwards - Ker (Tax Treaty Interpretation - The International Tax Treaties Service at page 7, quoted in *Razak's* case) says :

"12.06 A tax treaty provision may have an unequal effect. When State A imposes a tax which other State B does not impose (the situation contemplated above by W. S. Fisher Q.C. in *Mathewson*) a treaty may seek to limit the application of this tax and thus the chances of equality of effect. Nevertheless, even though this tax only exists in State A, the tax treaty will typically still be expressed in reciprocal terms - so that if and when the other treaty signatory State B does introduce such a tax, this treaty will also limit its application in State B.

Similarly, States may include a provision in a tax treaty to negate the application of a feature of State A's tax law which is only present in State A. If, as is usual, this provision is expressed in reciprocal terms, it will only become reciprocal in effect when State B subsequently enacts a comparable feature.

The fact that reciprocally expressed tax treaty provision may only have effect in one State does not rob this provision of any of its force."

It could be seen from the above that when a treaty is expressed in reciprocal terms, the reciprocity is not destroyed by reason of the absence of some features of a State law. UAE tax laws do not presently subject an individual person, who is a domicile or resident of that State, to tax. Such a feature does not affect the legal status of that person being "liable to tax" by reason domicile or residence. If and when UAE tax laws impose personal taxation and subject an individual to tax, the person can be said to have satisfied the "fiscal" as well as "legal" residency criterion. In *Asstt. DIT v. Green Emirate Shipping and Travels* [2006] 286 ITR (AT) 60 (Mum.), the Appellate Tribunal held (head notes) "A tax treaty not only prevents 'current' but also 'potential' double taxation. Therefore, irrespective of whether or not the UAE actually levies taxes on non-corporate entities, once the right to tax the UAE residents in specified circumstances vests only with the Government of the UAE, that right, whether exercised or not, continues to remain the exclusive right of the Government of the UAE."

The legal status under a treaty determines the jurisdiction of the Contracting States over person who is resident of one of them, in respect of his income depending upon the source. Whether the domestic laws subject a person or his income to tax is not relevant. The Supreme Court of Canada in *The Queen v. Crown Forest Industries Ltd (infra)* observed, "A factual proposition which merely informs domestic tax liability cannot constitute a residency criterion under the Canada-United States Income-tax Convention (1980)". In that case the Court held the Bahamian company (Norsk) to be resident of USA not by reason of residency criteria mentioned in the Convention but by reason of the fact that it conducted its business which was effectively connected with the United States and had income arising from that business which was also effectively connected with the United States. The business income of an enterprise under a treaty is taxable on this principle, which does not require residency status as defined in article 4.

In a Canadian judgment, *The Estate of Michel Hausmann v. Her Majesty, The Queen* [1998] Can. Tax Ct. LEXIS 1140 throws light on the principle that the benefit of a double taxation agreement would be available even if the other Contracting State in which a particular head of income is to be taxed, chooses not to impose on the same. A further extension of this principle to a situation when the State does not impose tax at all and thereby does not subject a person to tax, the benefit of double taxation agreement would still be available to him. Klaus Vogel observed in his book Double Taxation Convention, "Thus, it is said that the treaty prevents not only 'current', but also merely 'potential double taxation', and further, 'only in exceptional cases, and only when expressly agreed to by the parties, if exemption in one Contracting State dependent upon whether the income or capital is taxable in the other Contracting State, or upon whether it is actually taxed there'(see pages 26-29, third edition). Prevention of the future double taxation is also aimed by the treaty. If there is possibility or probability of such taxation, the treaty benefit cannot be denied. This is what the word 'liable' in the expression 'liable to tax' conveys, current or future double taxation. Thus, if there is a probability of tax liability in future, though not presently existing, the person qualifies for the benefit.

Legal status under the treaty is not the fiscal residence under the domestic law. Fiscal residence, as discussed in para 10.2B, is a place where a person is subject to tax for world wide income. The domestic law determines by laying down conditions under which a person is to be treated fiscally as 'resident'. It does not decide jurisdiction between two states, under a treaty. Legal status ('liability to tax'), as discussed above, decides which depends on various factors as set out in article 4, such as domicile, residence etc. Domestic law subjecting a person or requiring him to pay tax is not relevant.

The definition of "resident" in article 4 is linked to the definition of "person" in article 3, which definition includes "individual". If an individual person domiciled in UAE were intended not to be covered as observed by the Authority in *Razak's* case, there was no purpose of defining the expression "person" as including "individual" or providing tie-breaking rule in article 4(2). That rule would be operative if an individual happens to be resident of both UAE and India in terms of article 4(1). That situation would not arise, as according to the authority, an individual presently cannot be resident of UAE. The incorporation of the rule suggests a situation when an individual happens to be resident of both the States; and this be possible only if the expression "liable to tax" is read in the manner as Authority in *Mohsinally Alimohammed Rafik, In re* [1995] [213 ITR 317](#) (AAR) did. The treaty applies to "persons" [as defined in article 3(e) which includes an individual] who are residents "[as defined in article 4] of one or both of the Contracting States" [as defined in article 3(c), as meaning UAE or India as the context requires]. The Authority interpreted the expression "individual" as "who is a taxable entity under the taxation laws in force in one or both the Contracting States" and the expression "resident of a Contracting State."

Liability to tax - Three situations

There could be three situations—

- (1) A person is subject to tax and he pays tax;
- (2) He is subject to tax but does not pay tax because his income is exempt;
- (3) He is not subject to tax at all, but "liable to tax".

There is no dispute about the first two situations. He qualifies as "resident". As for the last, the situation is not different from the second. In respect of both, there is complete exemption. In one income, and in the other person, is not taxed. Liability to tax is subject related and not object related taxation. There is no difference when an individual is subject to but does not pay tax (income being exempt) or a source of his income is not subject to tax

(as capital gains in the UAE) and when he is not subject at all in the absence of law. In both cases, he could be said liable to tax.

To be a resident in terms and for the purpose of treaty provisions it is not necessary that he should be subject to tax. This is the only interpretation possible, as otherwise allocation of jurisdiction in terms of the treaty provisions would not be possible, in respect of an individual income earned for personal service [independent (article 14), dependent (article 15)]; as director's fee (article 16), entertainer and athlete (article 17), pensions [Government (article 18), non-Government (article 19)], student or apprentice (article 20), professor or teacher and researcher (article 21). All these articles use the expression "resident of a contracting State", which expression would carry the meaning as provided in the definition article 4(1), excepting where the context otherwise requires or it is defined differently for a specific purpose [see article 20(5)]. According to Authority for Advance Rulings that the comment that "the treaty is unworkable insofar as individuals are concerned, may not be entirely correct as individuals who are resident in India are benefited but residents of UAE are not [see *Michael Edwards-Ker (supra)*] in regard to unequal effect of treaty]. We conclude our discussion of article 4(1) recording our agreement with the following commentary of Philip Baker :

"The article thus, is linked to the definitions of 'person' in article 3 and/or 'resident of a Contracting State, in article 4.

Though brief, the article is of vital importance. Those who cannot demonstrate that they come within the definitions of a person and a resident of a contracting State are not able to claim the benefit of the convention' ".

There cannot be any dispute about the observation of Philip Baker. The test is applicable in a particular case so that the benefit of the treaty is not available to a person who is not a *bona fide* resident of India or UAE, as in case of treaty shopping and not to all and every individual person by interpreting the expression "liable to tax" in such a manner so that none of the *bona fide* resident or domicile of the UAE qualifies.

The said articles use two expressions "resident of a Contracting State" and "resident of other Contracting State". If one refers to an Indian, the other refers to UAE individual (see definition clause 3(c)). But it is not to be, according to Razak which interprets the expression "resident of a Contracting State" as defined in section 4(1) not presently covering any individual person resident or domicile in UAE. Such an interpretation would render the said articles unworkable in the absence of who the expression "resident of a Contracting State (or other Contracting State)" refers if not an individual person of the UAE.

Similarly, article 11 (interest) and article 12 (royalties) would be unworkable in so far as individual person is concerned. Paragraph 1 thereof reads as follows:

"Interest (royalties) arising in a contracting State and paid to a resident of the other Contracting State may be taxed in that other State."

Article 10(1) (dividends) reads similarly.

The paragraph operates on the premise that (1) income arises in a Contracting State (say India) and (2) it is paid to a resident of other Contracting State (say UAE). It contemplates two entities, a payer (an Indian resident) and a payee (UAE resident). If payee does not exist, it would be inoperative. This would be so in case of an individual person, because according to Razak, he is not a resident of UAE in terms of article 4, and cannot be a payee. An interpretation which renders a provision redundant and unworkable is impermissible.

On the meaning of "liable to tax", the commentary on the OECD model states that the treaties "do not normally concern themselves with the domestic laws of the contracting State laying down the conditions under which a person is to be treated fiscally as resident and consequently is fully liable to tax in that state".

Paragraph 8.2 of the OECD Commentary on Article 4 states:

"Paragraph 1 refers to persons who are "liable to tax" in a Contracting State under its laws by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as

residents for purposes of the Convention (*see*, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11)."

The criteria domicile, residence, place of management or other resembling any of these are generally recognised under the international law to justify world-wide taxation. Any other under the domestic law does not justify as held by the Canadian Supreme Court in *Crown Forest* case.

Crown Forest case Crown Forest case

10.5-1 The concept "liable to tax" was at issue before the Supreme Court of Canada in *The Queen v. Crown Forest Ltd. et al.* 95 DTC 5389 (SCC). A Canadian company rented barges from a Bahamian company, whose only office and place of business was in the United States. Although Bahamian company was not subject to tax in the US income-tax on the rental payments received from the Canadian company, the payments were subject to a 25 per cent withholding tax under Canada's domestic tax legislation. However, the Canadian payer argued that the provisions of article XII(2) of the Canada-US tax convention applied to reduce the withholding tax to 10 per cent. The conclusion rested on the question whether the Bahamian company was a resident of the US for the purposes of the convention. The relevant provision of the US-Canada convention is article IV(1), which reads as follows:

"For the purposes of this convention, the term "resident of a Contracting State" means any person that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature."

The criterion for holding a person liable is : domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of similar nature. According to the Supreme Court, the Bahamian company did not qualify because of the absence of any of the criteria. The Supreme Court stated that while the Bahamian company was liable for tax in the US to the extent that its income was effectively connected to a trade or business carried on in the US, but this criterion was not one of the criteria mentioned above. Nor was it a criterion similar to those mentioned. Accordingly, the Bahamian company was not a resident of the US for the purposes of article IV of the treaty.

The Bahamian company was liable not because any of the criteria mentioned in article IV of the Canada-US treaty, but because of any other factual basis.

Azadi Bachao Andolan case Azadi Bachao Andolan case

10.5-2 In *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) (SC), the expression "liable to taxation" was discussed in detail. It arose out of the issue whether avoidance of double taxation could mean that a person has to pay tax at least in one country and that a person does not pay tax in any country whatever. The issue arose out of a circular of the Central Board of Direct Taxes (No. 789 dated 13-4-2000) which, *inter alia*, stated that Foreign Institutional Investors and another investment funds etc. which are operating from mauritius are invariably incorporated in that country and these entities are "liable to tax" under the Mauritius Tax law and are therefore considered as residents of Mauritius in accordance with DTAC, and clarified that wherever a Certificate of Residence is issued by the Mauritius Authorities will constitute sufficient evidence for accepting the status of residence as well as the beneficial ownership or applying the DTAC accordingly. It also directed that the FIIs etc. which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13.

According to this circular capital gains are not to be taxed in India. They are not taxed in Mauritius as according to their laws they are not taxable. Thus, they are neither taxable here and nor there. The FIIs etc. do not pay tax. The question was whether the phrase "liable to tax" as used in article 4(1) is the same as "pays tax".

The Supreme Court observed that merely because exemption has been granted in respect of taxability of a particular source of income, it cannot be postulated that the entity is not "liable to tax". The court held as follows :

"In our view, the contention of the respondents proceeds on the fallacious premise that liability to taxation is the same as the payment of tax. Liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of the DTAC what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. If this were not so, the DTAC would not have used the words "liable to taxation", but would have used some appropriate words like 'pays tax'. On the language of the DTAC it is not possible to accept the contention of the respondents that offshore companies incorporated and registered under MOBA are not "liable to taxation" under the Mauritius Income-tax Act; nor

is it possible to accept the contention that such companies would not be "resident" in Mauritius within the meaning of Article 3 read with Article 4 of the DTAC."

The Supreme Court thus held that a Mauritius company which did not have to pay any capital gain tax under the domestic law, was still liable to tax and hence a treaty resident.

Person liable to tax - Partnerships, funds, charities Person liable to tax - Partnerships, funds, charities

10.5-3 Certain funds or charitable entities may be exempted from tax, if they meet the requirements for exemption specified in tax laws. They are considered to be liable to tax and resident for the purposes of the Convention. Certain entities which are fiscally transparent entities such as partnerships, trusts and certain estates are not liable to tax and therefore, not resident. But the benefit could not be denied to partners or beneficiaries who derive income through such entities. Income thus derived is considered to be derived by a resident of a State. Paragraph 1(b) of article 4 of the Indo-US tax treaty reads : "in the case of income derived or paid by partnership, estate, or trust, this term (residence) applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of the resident, either in its hands or in the hands of the partners or beneficiaries." Paragraph 8.4 of the OECD Commentary on article 4 provides "Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be resident of that State. In such a case, since the income of the partnership 'flows through' to the partners under the domestic law of the State, the partners are the persons who are liable to tax on that income and are thus appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity."

The matter has been discussed in detail in chapter 7.

Person liable to tax - By reason of physical nexus between him and the State Person liable to tax - By reason of physical nexus between him and the State

10.6 The concept of "residence" defines the scope of total income which is subjected to charge to tax. In India a resident is taxed on worldwide income; whereas a non-resident, on income derived from sources within the country. Criterion is not the same for every country. Different countries have prescribed different standards for determining the taxpayer's territorial nexus. The following paragraph from Cahiers de droit fiscal international, Vol. LXXXVIIb (2002 Oslo Congress) page 25, clarifies:

"Countries using residence as a basis for their taxing jurisdiction give consideration to the taxpayer's personal attachment to the country concerned. To determine such attachment they apply various tests which are not mutually exclusive: permanent residence under immigration laws (*e.g.* the United States and Brazil); availability of a permanent home (*e.g.* Austria, Sweden, Finland, France, Mexico and Switzerland); presence for a certain period of time (*e.g.* United Kingdom, New Zealand, the United States, Norway, Spain, Finland and India); presence in the country for professional purposes for a certain period of time (*e.g.* Japan, France and Switzerland); situation of centre of economic or social interests (*e.g.* Netherlands, Italy, Spain and France) and, even in one case, nationality (Argentina). The application of some of these tests requires a facts and circumstances analysis."

Resident for the purposes of a tax treaty is the person who is liable to tax, under the domestic law of the concerned state, by reason of some nexus between him and the state. That nexus is provided (1) by reason of his physical connection such as "domicile" "residence", or "place of management", or (2) by other criteria for taxability such as location of the income irrespective of any such physical connection. Even a person who is non-resident according to the domestic law becomes resident for the purposes of the treaty, or *vice versa*.

Person liable to tax - By reason of "any other criterion of similar nature" Person liable to tax - By reason of any other criterion of similar nature

10.7 The words "any other criterion of similar nature" appearing in paragraph 1 cannot be construed analogously to the preceding words "domicile", "residence" or "place of management". Such a construction would result in denial of relief in many cases, although the taxpayer may be actually subjected to tax. The criterion for fixing the tax liability under the domestic taxing statute is not only confined to domicile, residence or place of management, but also to any other criterion providing the nexus for taxability under the laws of the state (*see AAR No. P-9 of 1995, In re* decided on the 22nd December, 1995 *X Ltd. In re* [1996] [86 Taxman 252](#) (AAR). The situs of income as

arising or accruing or deemed to be so arising or accruing in a country also fixes the tax liability. That liability is not attributed to the person's "domicile", "residence", or the "place of management". The nexus is provided by the locus of the income. Even a non-resident is liable to tax if such a nexus exists. Such a non-resident is resident for the purposes of tax treaty, in terms of paragraph 1. *See also Crown Forest case* (Para 10.5-1)

Residence - State, sub-division or local authority

10.7A The expression "residence" includes a State, sub-division or local authority thereof. The definition includes a State, but does not, however include a sovereign. During the last few decades, there has been an enormous change regarding the conception of the function of the Government. Formerly the main functions of the State were to maintain law and order and to protect the State from external aggression. Its sphere of activities, as a sort of night watchman was confined to defence, public administration, tax collection and administration of justice. But in modern times, the State is a service State or a welfare State and has become an instrument of economic and social policy. In a model welfare State like India, the State performs several services including industrial and commercial activities and services. The functions of the State are no longer restricted to traditional functions of a sovereign. The State has entered into commercial activities. This has modified the doctrine of which gives immunity to acts of governmental nature, described in Latin as *jure imperi*, but no immunity to acts of commercial nature, *jure gestionis*. In *Rahimtoola v. Nizam of Hyderabad* (1957) 3 All ER 441, Lord Denning said that if the dispute concerns, for instance, the commercial transactions of a foreign Government, whether carried on by its own departments or agencies or by setting up separate legal entities, and it arises properly within the territorial jurisdiction of the English Courts, there is not ground for granting immunity. Again in *Thai-Europe Service Ltd. v. Government of Pakistan* (1975) 3 All ER 961 (CA), it was stated that a foreign sovereign has no immunity when it enters commercial transaction with a trader.

The matter is to be decided with reference to the particular action, the activity in which the State or instrumentality of the State is engaged. Thus, when the State or its instrumentality ventures into corporate world and purchases shares of a company, it assumes to itself the ordinary role of the shareholder. Similarly, even if the entire share capital of the companies has been subscribed by the Government, it cannot be predicated that the companies are themselves owned by the Government as the companies incorporated under the Companies Act have a corporate personality of their own, distinct from that of the Government (*Western Coalfields Ltd. v. Special Development Authority* AIR 1982 SC 697). Thus, a company, though fully owned by the Government, when incorporated has its own identity and cannot be considered department of the Government [*Steel Authority of India v. Sri Ambica Mills Ltd.* (1998) 92 Comp. Cas. 120 (SC)]. Justice J. C. Shah observed as follows in *State Trading Corporation of India v. CTO* AIR 1963 SC 1811 :

"The State Trading Corporation has been constituted under the Indian Companies Act as a private limited company may be wound up by order of a competent court. Though it functions under the supervision of the Government of India and its directors, it is not concerned with performance of any governmental functions. Its functions being commercial, it cannot be regarded as either the department or an organ of the Government of India. It is a circumstance of accident that on the date of its incorporation and thereafter its entire shareholding was held by the President and two secretaries of the Government of India."

The above concept is analogous to the "qualified governmental entity" of the US Model Convention, which has expression has been defined, *inter alia*, to mean any person or body of persons that constitutes a governing body of a Contracting State, or a political sub-division or local authority of a Contracting State.

Residence - Person of State who is liable to tax in respect only of income from sources in the State, not resident of that State

10.7B The expression "resident of a Contracting State" does not include a person who is liable in that State in respect only of income from sources in that State or capital situated therein. That person is not liable by reason of his domicile, residence or place of management in respect of his worldwide income. He is liable only by reason of the income having its source in that State. For example, an enterprise of other Contracting State with a permanent establishment in a state is not, by virtue of that permanent establishment, is resident of that state. The enterprise is subject to tax only with respect to income that is attributable to the permanent establishment, not with respect to worldwide income, as is a resident of that state. Similarly, income from investment made by a foreign consular

official of other Contracting State posted is taxable, but not all other income from foreign sources. He is not considered resident of that state for the purpose of the treaty.

The matter was discussed in by the Supreme Court of Canada in *The Queen v. Crown Forest Industries Ltd.* (95 DTC 5389, see paragraph 10.5-1) The Court observed as follows:

"The basis of Norsk's (Bahamian company) liability for taxation in the United States emanates from the fact that it conducts its trade or business which is effectively connected with the United States and has income arising from that business which is also effectively connected with the United States. Although the fact that its 'place of management' is located in the United States is one factor contri-buting to the finding that its trade or business is connected with the United States, it does not constitute the basis for Norsk's tax liability in the first place. A factual proposition which merely informs domestic tax liability cannot constitute a residency criterion under the Canada-United States Income-tax Convention (1980). The only way for Norsk to benefit from residency status under the Convention is if the source taxation on a business is effectively connected with the contracting party constitutes a criterion similar to the other enumerated criteria in Article IV (residence, place of management, place of incorporation, domicile). It is not similar, since all of the other criteria constitute grounds for taxation on worldwide income, not just source income. The parties to the Convention intended only that persons who were resident in one of the Contracting States and liable to tax on their 'world wide income' be considered 'residents' for purposes of the Convention. Norsk is therefore not a 'resident' of the United states for purposes of article IV of the Convention."

The above case seems to confirm that a person must be linked to a Contracting State by a connecting factor which is generally recognized in international tax law as justifying world wide taxation before that person can be a resident of that Contracting State (Philip Baker in Double Taxation Conventions).

Thus, foreign diplomats and consular staff who may be subject to tax only on domestic-source income are not resident. An off-shore company is not liable to tax if its world wide income is not taxable, *i.e.*, if its foreign income and capital are exempt. The OECD Commentary in paragraph 8, however, stated that the provision has to be interpreted strictly because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended.

Residence - IndividualResidence - Individual

10.8 A person who is an individual is a resident of a contracting State if under its laws he is liable to tax therein by reason of his domicile or residence, besides being so liable by the reason as discussed in the preceding paragraph. "Domicile" or "residence" provides the nexus for such determination. In case he qualifies as resident of both states, the tie breaking rules as provided in paragraph 2 applies, so that he be assigned the residence of either.

Residence - MeaningResidence - Meaning

10.9 The term "resident" according to the New Oxford English Dictionary (edition 1993) means, *inter alia*, residing, dwelling or having an abode in a place, staying regularly in or at a place for the performance of official duty or work, study, etc. A person resident of state should be understood as a person residing, dwelling or having an abode or a person staying regularly in that state for the performance of official duty or study. The word "residence" has different meaning in different branches of law. For some purposes it is sufficient to describe a person resident where he works, while for other purposes this is not sufficient. For some purposes, a person is resident where his family lives, while for other, where he is himself present. For some purposes "residence" connotes some degree of permanence, while for others it may be transitory (*see* Dicy's Conflict of Laws, seventh edition, p. 95). Residence means actual place of residence and not a legal or constructive residence. It does not connote the place of origin—*K.C. Sashidhar v. Smt. Roopa* AIR 1993 Kar. 20. For taxation purposes it may be taken to mean the place where the wealth or the income is habitually or permanently consumed or otherwise utilised.

Residence - Domicile and citizenship - DistinctionResidence - Domicile and citizenship - Distinction

10.10 It is necessary to bear in mind the distinction between the kinds of the status, *viz.*, domicile, residence and citizenship. "Domicile" has reference to civil rights; "residence", to the physical connection with a particular territory; "citizenship", to the political status. Domicile and residence under some circumstances, coincide. When a person is having a domicile of, or is domiciled in, a particular country he is governed by the law of that country. The 'domicile', as aforesaid, has reference to a system of law by which a person is governed. It may have reference

to a part of the country, as in the case of Great Britain, where a person having a Scotch domicile has a different system of law applicable to him, while if he were to have an English domicile, another system of laws applies to him—*CED v. Dr. Ida Bella Scudder* [1980] 123 ITR 104 (Mad.).

Domicile - Meaning

10.11 Domicile means one's connection with the territory, and not with the membership of the community which is at the root of the notion of citizenship or nationality—*Shrivastava Rajeshkumar Satyanarain v. The Chairman Selection Committee* AIR 1987 Guj. 4. It denotes relationship between a person and a particular territorial unit possessing his own system of law which is different from nationality or citizenship. It determines a person's personal status and the law applicable to him in the matters such as majority or minority, marriage, divorce or succession—*K. Radha Krishnan Nayyar v. Radha* AIR 1992 J & K 1. By domicile is meant a permanent home—*Winans v. Attorney General* [1904] AC 287 (HL). A person may be said to have home in a country if he resides in it without any intention of at present removing from it or for an indefinite period (*see* Dicy's Conflict of Laws, seventh edition, p. 85). Mere residence at a particular place is not the only test to determine the domicile and the court is required to consider the quality and the character of the residence. The domicile of origin is determined by operation of law at birth. The domicile of choice is acquired later by the actual removal of an individual to another country accompanied by his *animus manendi*. The state of mind or *animus manendi* demands that the person whose domicile is the object of enquiry should have formed a fixed and settled purpose of making his principal or sole permanent home in the country of his residence or, in effect, he should have formed a deliberate intention to settle there—*Kedar Pandey v. Narain Bikram Sah* AIR 1966 SC 160 and *Shrivastava Rajeshkumar Satyanarain v. Chairman Selection Committee* AIR 1987 Guj. 4. The fiscal domicile of a person may be different from political domicile.

Domicile - Fiscal

10.12 For tax purposes, domicile has a more practical meaning, in the sense of residence, the physical presence in the country. In a majority of cases, the domicile and residence coincide. The question what "resident" means is one of law to be decided according to the meaning of the provisions of the tax laws of the contracting States, and the question where a person is resident within that meaning is one of fact. The criterion or determination of residence may differ substantially from state to state. A person may be resident of one and also of the another state according to the criterion contained in their respective tax laws. Dual residence may be the consequence resulting in taxation of the global income in more than one country. Tax treaties, therefore, contain special provisions to avoid dual residence by listing a number of precise criteria for assigning it to one of the contracting States.

According to Income-tax Act, 1961, an individual person is resident in India in any previous year if he is in India in that year for a period or periods amounting in all to :

- (a) one hundred and eighty two days or more; or,
- (b) sixty days or more and has also been in India for a period or periods amounting in all to three hundred and sixty-five days or more within the preceding four years. However, the period(s) of sixty days is to be substituted to 182 days in case of a person who is a citizen of India :
 - ◆ being outside India comes on visit to India in any previous year (this provision is also applicable to a person of Indian origin);
 - ◆ leaves India in any previous year for the purpose of employment outside India or as a member of the crew of an Indian ship.

The individual person who is not resident is non-resident [*see* section 2(30) of the Act].

But a non-resident person according to the Indian Income-tax Act, 1961, could be resident for the purposes of a tax treaty, as already discussed. Thus the fiscal residence and the treaty residence may not coincide. The person can be resident of both contracting States. The tie has to be broken. Rules for that purpose are contained in paragraph 2 of article 4.

Residence of individual - Tie breaking rules

10.13 Paragraph 2 contains tie-breaking rules in case a person who is an individual is found to be resident of both the contracting States in terms of paragraph 1. These are as follows and to be applied in the same order for treating him to be resident of a State :—

1. where a permanent home is available to him; and in case it is available in both the states, then

2. with which his personal and economic relations are closer (centre of vital interests); and in case his centre of vital interest cannot be determined, then
3. in which he has an habitual abode; in case has habitual abode in both the states or in neither of them, then
4. of which he is a national; in case he is a national of both the states or of neither of them, then
5. by settlement by the competent authorities of the contracting states.

Philip Baker in his Double Taxation Conventions stated :

"The tests are to be applied in serial order: in one decision of the Conseil d'Etat (Decision of May 13, 1983, (1983) 35 Droit Fiscal 1,030 discussed in (1983) ET 355) an agreement between the Competent Authorities of France and the US as to the residence of an individual was struck down on the grounds that the authorities had resorted to mutual agreement under the fifth leg of the tie-breaker when the second test (centre of vital interest) should have determined the issue."

The above rules are applied to the facts existing during the period when the residence of the taxpayer affects tax liability, which may be less than entire taxable period (*see* OECD Commentary, article 4, paragraph 10). The Commentary illustrated by an example. In one calendar year an individual is a resident of State A under the State's tax laws from January 1 to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, for both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.

The above rules use the expressions "permanent home", "centre of vital interests", "habitual abode", which have not been defined in the Convention, but explained in the Commentary.

Residence of individual - Permanent home Residence of individual - Permanent home

10.13-1 An individual is treated resident of a Contracting State if he has a permanent home in that State, *i.e.*, where he owns or possesses a home which is permanent where he has arranged and retained for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay to be of short duration (*see* OECD Commentary, article 4, paragraph 12). Whatever the form whether house or apartment rented or belonging to him, rented furnished room, it must be permanently available in the sense that he has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of stay which is necessarily of short duration (*see* OECD Commentary, paragraph 13)

"Permanent" is to be understood in an objective sense to be opposite of "for a limited period"—*Dr. Rajni Kant R. Bhatt v. CIT* (AAR No. 268 of 1996 dated the 1st August, 1996). A person may be said to have his home in a country if he resides in it without any intention of at present removing from it permanently or for an indefinite period. But a person does not cease to have his home in a country merely because he is temporarily resident elsewhere; and a person who has formed the intention of leaving a country does not cease to have his home in it until he acts according to that intention (*see* Dicey's Conflict of Laws, 7th edition, p. 85). An intention to return to one's country of domicile after an indefinite stay overseas does not mean that a permanent home is retained in the country of domicile. The intention to return is but one of the factors for consideration in determining the individual's place of abode—*FCT v. Appellate* 79 ATC 4307. Even though a person retains his home in a country (because he is not able to sell it), and has not formed an intention to retain indefinitely in another country, the fact that he agreed to go overseas for 3 years period is not enough to make his stay only temporary—*FCT v. Jenkins* 82 ATC 4089. Ownership of any interest in the property is not necessarily determinative of "home"; nor does the temporary return of a person from the country of his residence to the country of his origin, on holidays, or compassionate purposes. The determinative factor is the existence of the center of vital interests which gravitates person towards it (discussed later).

Residence of individual - Permanent home, intention of a person Residence of individual - Permanent home, intention of a person

10.13-2 If a person has been living without any intention of removing from it, he can be said to have a permanent home there. How a person's intention be gathered if that alone is the determinative factor. There are no set formula or principles. Its existence could be inferred from various circumstances surrounding the person's acts, though such

circumstances may vary from person to person. A circumstance which is treated decisive in one case may not be relied on in the case of another.

Long residence or purchase of land or taking of a lease or residence in furnished lodgings or hotels, marriage with native of the country or the presence of a man's wife or children in a country or the existence of a business interest or the ownership of a property, have been relied upon in some cases to support a finding of *animus manendi*, while in others, such circumstances have been discarded (*see* Dicey's Conflict of Laws, 7th Edn. pp. 99-101). Other countless circumstances have been taken into account to determine a person's intention. Such circumstances though not exhaustive, as pointed out in Dicey's Conflict of Laws, are: the form and the content of the will, the exercise of the political right, the fact of neutralisation, the education of the children, the membership of religious and charitable associations, the relations between a man and his family, his character, his social habits, and even the way in which he spells his name. A person's tastes, habits, conduct, actions, ambitions, health, hopes and projects are all regarded as keys to his intentions— *Casdegali v. Casdagali* [1919] AC 145.

Intention cannot have formal expression unless the conduct, the acts, and circumstances of a person's case point it out. Sometimes such intention is expressed in a statement or document by that person. Declarations as to the intention are regarded in determining the question of domicile. But they must be examined by considering the persons to whom, the purpose for which and the circumstances in which they are made, and they must further be informed and carried into effect by conduct and action consistent with the declared intention.

The expression "residence", "abode", "home", or "dwelling place" means a place where an individual person is supposed to live and sleep. Some territorial connection amounting to residence must subsist between the person and the place which must be a house or a portion of the house which could be regarded as an abode or home. The connotation of a dwelling place is different from a mere residence or a mere house in which one finds oneself for a temporary or short period. A dwelling place connotes a sense of permanency, a sense of attachment which would permit a person to say that his house is his home. Undoubtedly a man may have more than one house: he may have home at different places: but with regard to each one of those he must be able to say that it is something more than a house or a mere residence. The test is that when you go to a house you should really go home, irrespective of whether such a dwelling place is maintained by you or by someone else, or the house is in your or someone else's name or belongs to you or to that someone else. In other words with regard to that house where you go and live, you must be able to say that it is your abode or home—*CIT v. K.S. Ratnaswamy* [1980] [122 ITR 217](#) (SC) and *CIT v. Fulabhai Khodabhai Patel* [1957] [31 ITR 771](#) (Bom.).

Residence of individual - Centre of vital interest Residence of individual - Centre of vital interest

10.13-3 If an individual has a permanent home in both the States, preference is given to the State with which the personal and economic relations of the individual are closer (*see* OECD Commentary, article 4, paragraph 14)

Home is something different from domicile, being simply the location for the time being, which constitutes the centre of gravity or the centre of vital interest of domestic life of a person. In the case of a married man, the home would generally be the place where his wife and children reside, and in case of a single person, the place the centre of his interests and affairs lay. The centre of vital interests of an individual can be taken to mean the place in which the individual has his closest personal or business relationships. In *Mohsinally Alimohammed Rafik, In re* (AAR No. 206 of 1994, decided on the 23rd December, 1994), the Authority for Advance Ruling held as follows :—

"The applicant, no doubt, has a permanent home available to him in Dubai and in India. However, his personal and economic relations are closer to Dubai rather than with India...The total remuneration drawn by the applicant and his share of the profit by way of salary and commission from Dubai firm amounts to Rs. 23 lakh whereas the Indian income, comparatively speaking, is definitely small. Quite apart from the actual figures of income, it is clear that the applicant has left India for Dubai several years back. In India, he only derives a small income as a sleeping partner in two figures and from a property which he is retaining in India as a permanent home in the eventuality of his having to return to India sooner or later. He has been carrying on his income earning activities in Dubai and is practically staying in Dubai throughout the year with his wife and other members of the family. His children have been admitted to schools in Dubai and are educated there. These facts leave no doubt that the personal and economic ties of the applicant are closer with Dubai than with India and the centre of his vital interests is Dubai, not India."

To ascertain with which of the two States his personal and economic relations are closer, regard may be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property etc. The circumstances must be examined as a whole, but it is nevertheless

obvious that considerations based on the personal acts of the individual must receive special attention (*see* OECD Commentary, para 15).

Philip Baker illustrated the application of the test of centre of vital interest by quoting several Canadian decisions, in his book *Double Taxation Conventions* :

"There have been several Canadian decisions on the meaning of the phrase centre of vital interests. In *Michael Hertel v. MNR* [1993] 93 D.T.C. 721 (Tax Court of Canada)] the taxpayer was a resident of both Canada and West Germany and had permanent homes in both countries. However, he lived with his wife and children in Germany, where his business was located, he had ties with the community and church ties. The Tax Court concluded that his centre of vital interests was in Germany. In *Henry and Louis Endres v. MNR* [1998] 98 D.T.C. 1101 (Tax Court of Canada) the taxpayers were residents of the US and Canada, but their home in Nova Scotia was leased with minimal furniture, their children were at school in the US and the taxpayers' business and social lives were in the US. The Tax Court concluded that their centre of vital interests was in the US. Finally, in *Dale Boston v. R* [1997] 98 D.T.C. 1124 (Tax Court of Canada) the taxpayer moved from Canada to Malaysia to take up an employment. His wife and family remained in Canada, though his relations with his wife were strained. The Tax Court concluded that he was not resident in Canada, but if he were, the tie- breaker fell on the side of Malaysia. Though he had permanent homes in both the countries, his personal life was centered in Malaysia and his family in Canada was not a strong enough magnet to draw him back other than for two short periods during three years."

Residence of individual - Habitual abode Residence of individual - Habitual abode

10.13-4 If residence cannot be determined by reference to centre of vital interest, other subsidiary criteria be resorted to; first, habitual abode, then nationality, and then mutual agreement between the States. Habitual abode test is applied (a) on centre of vital interest test failing to determine which one of the two permanent homes is residence, or (b) where permanent home is not available in either of the States. In the first case, centre of vital interest tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual and not only at the permanent home in the State in question but also at any other place in the same State (*see* OECD Commentary, article 4, paragraph 17). In the second case, all stays in the State must be considered without it being necessary to ascertain the reasons for them (OECD Commentary, paragraph 18). What should be length of time for comparison, there is no rule. It must, however, cover sufficient length of time for it to be possible to determine whether the residence is habitual (*see* OECD Commentary, paragraph 19).

What is habitual abode has not been defined in the Convention. The Commentary explains it to be place where a person stays more frequently.

Mere temporary residence or residence by compulsion at a place, however, long cannot be equated to or be treated as a place of ordinary residence (*see Bhagya-lakshmi v. K. Narayana Rao* AIR 1983 Mad. 9). There should be habitual abode. The expression "habitually" means repeatedly or persistently. It implies a thread of continuity stringing together similar acts. Repeated, persistent, and similar but not isolated, individual or dissimilar acts are necessary to justify an inference of habit. It connotes frequent of acts of commission or omission of the same kind. The idea of "habit" involves an element of persistence and a tendency to repeat the acts of the same class or kind—*Vijay Narain Singh v. State of Bihar* AIR 1984 SC 1334.

If a person has been living persistently and repeatedly at a place, *i.e.*, more frequently, he can be said to be habitually residing in that place.

Residence of individual - Dr. Rajni Kant's case Residence of individual - Dr. Rajni Kant's case

10.13-5 The aforesaid criteria were applied by the Authority for the Advance Ruling in the case of *Dr. Rajnikant R. Bhatt v. CIT* (AAR No. 268 of 1996, 1st August, 1996). The question before it was whether the applicant was a resident of UAE or India. He was a resident of India as well as UAE within the meaning of article 4(1) of the tax treaty between the two countries. For breaking the tie, rules as provided in clause (2) of that article were applied. A permanent home was found to be available to him in both the countries, personal and economic relations were found equally close with both. The matter was then decided on the criterion of habitual abode. The Authority held as follows:—

"...The applicant here has a permanent home in Abu Dhabi where he is employed for an indefinite period and where he resides continuously during his stay in Abu Dhabi making his home there. The mere fact that the duration of his stay in Abu Dhabi is not certain and that he may return to India eventually will not render his

home in Abu Dhabi any less a permanent home available to the applicant. "Permanent" in this connection, should be understood in an objective sense to be the opposite of "for limited" period. A house taken up for the length of the applicant's stay in Abu Dhabi which may last several years, if not permanently, cannot be said to be a house taken for a limited period. It is also common ground that the applicant has a permanent home in India where his wife and children are staying. In fact, there is also a clinic in India previously run by the applicant, run now by his wife who is also a doctor, though it is stated that it is now in a dormant state. In the result, the applicant must be considered to have a permanent home available to him in both the states.

11. This takes on to a consideration of the second part of sub-clause (2). Under this part of the sub-clause, a person will be considered to be a resident of that state with which his personal and economic ties are closer. In the present case, the personal ties of the applicant in India are clearly more dominant. Even, according to him, he does not wish to take his family to the UAE and has got reasons for keeping them here. So far as economic ties are concerned, he has income and property in both the places. On behalf of the Department it is pointed out that the value of the assets and income in India far outweigh the value of the assets and income at Abu Dhabi. This is true but, in the opinion of the Authority, the closeness of the economic ties cannot be determined entirely on the basis of an arithmetical comparison of the value of assets or the quantum of income. Here, clearly, is an applicant whose vital interests are divided between the two states. His economic interests lie in his professional work at Abu Dhabi. However, since, for reasons mentioned already, he is not able to take his family with him, he does make investments in India. It is no doubt possible that, at a future date, he may be returning to India. But for the present, it is very difficult to say which of the two states is closer to him from the point of view of the personal and economic ties. In this state of the facts, the authority is inclined to hold that it is very difficult to determine precisely the centre of vital interest of the applicant within the meaning of sub-clause (a) of clause (2) of article 4. In Double Taxation Conventions and International law by Philip Baker (2nd edn.), certain cases have been referred to at pages 130 to 131, where personal and economic interests point in different directions. In two Dutch cases, both concerning individual whose families were living in Holland but whose work was in Germany, the Amsterdam Court gave preference to the person interest in Holland over the economic interest in Germany. On the other hand, cases have also been cited where the taxpayer having permanent homes in France and Spain and income from countries, the Court found itself unable to determine in which state he had his centre of vital interest. This determination must mainly be a question of fact. On the facts of the circumstances of the case, the Authority is of the opinion that this is a case in which it is not possible to determine in which of the two countries the applicant has his centre of vital interest.

12. In view of the above conclusions, one has to turn to the terms of sub-clause (b) of clause (2) of article 4. According to this clause, a person has to be treated as resident of the state in which he has his habitual abode. That, in the present case, there can be no doubt, is Abu Dhabi. The Authority is, therefore, of the opinion that the applicant should be treated as a resident of UAE for the purposes of the DTAA".

Residence of individual - Permanent home-factors, summing up Residence of individual - Permanent home-factors, summing up

10.13-6 Discussion in the preceding paragraphs point out to the following factors which are normally taken into account for determining permanent home:—

- ◆ Length of a business interest;
- ◆ Accommodation arrangement, viz., purchase of property or taking one on lease, hiring a furnished lodging or staying in a hotel;
- ◆ Existence of a business interests;
- ◆ Ownership of a property;
- ◆ Presence of a person's family;
- ◆ Financial ties such as bank accounts, investments, superannuation arrangements.

Residence of individual - Nationality and tie-breakingResidence of individual - Nationality and tie-breaking

10.14 The criterion of nationality is applied to break the tie if the preceding criteria viz., permanent home, centre of vital interests, or the habitual abode, are unable to do. Nationality means place of birth—*Minor P. Rajendran v. State of Madras* AIR 1968 SC 1012. The fundamental basis of man's nationality is a continuing relationship

between the sovereign state on the one hand and the citizen on the other. This legal relationship involves rights and corresponding duties upon both, viz., citizen and the state. Nationality is, therefore, to be taken into consideration for determining the residence of an individual person after the other criteria having failed.

Residence of individual - Mutual agreement and tie-breaking

10.15 The last in the list of the tie breaking rules is the settlement by mutual agreement between the competent authorities of the contracting states, if every else rule has failed to decide the matter.

Residence other than individual - Tie breaking rule

10.16 Paragraph 3 is the tie-breaking rule when a person other than the individual is found to be resident of both the contracting States on the terms of paragraph 1. It provides that it shall be deemed to be a resident of the state in which the place of effective management is situated. The criterion for paragraph 1 is the place of management; for paragraph 3, the place of effective management.

Paragraph 3 contains the tie-breaking rule in case of a person other than individual, i.e., a company or any other body of persons etc., in terms of paragraph 1 if found to be having the place of management in, and thereby of resident of, both the Contracting States. The claim of the State is preferred State where effective place of management is situated. The effective place of management is the place where the company etc., is actually managed, i.e., where key management and commercial decisions necessary for the conduct of the business of the enterprise are taken.

Residence other than individual - Place of management and place of effective management

10.16-1 As aforesaid, paragraph 3 of article 4 contemplates not the place of the location of the management generally, but the location of the place of effective management.

OECD Commentary on Article defines the expression effective management, in para 24, as :

"...The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can be only one place of effective management at any one time."

Place of effective management refers to the place where, factually and effectively, the day-to-day affairs of the company are carried out and not to the place in which may reside the ultimate control. Since a company is a legal abstraction, it can act only through its agents who in fact control and determine the management and are the centre of its personality. Such agents are generally called the directors, being the "directing mind and will" of the company. They manage, control and direct the business of the company. They are not the employees. An employee even if authorised by the board of directors by a resolution to be a person in the control of the affairs of the factory cannot be so. Such an employee carry orders from the above. It makes no difference that he has been given some measure of discretion also and has supervisory control. It can at best be treated to be in the immediate control of the factory or having day-to-day control over the affairs of the factory, the ultimate control being retained by the company itself— *J.K. Industries v. Chief Inspector of Factories and Boilers* [1997] 88 Comp. Cas. 285 (SC). Ultimate control, and the effective management (day-to-day control), are two different concepts. Paragraph 3 refers to the place where the company is actually managed, and not where it is controlled.

For purposes of breaking the tie between the two states the choice is between them where the location of the effective management abides. Location at the third place is not a relevant factor. Applying this criterion, the Authority for Advance Ruling held in a case before it [*see AAR No. P. 9 of 1995, In re*, decided on 22-12-1995 *X Ltd. In re* (1996) [86 Taxman 252](#) (AAR)] held:—

"Looked at from this point of view, the applicants do not have any place of management at all in India while they do have one in Mauritius. On a proper construction of article 4 of the Double Taxation Avoidance Agreement, therefore, the applicant companies have to be treated as resident of Mauritius for the purposes of the Double Taxation Avoidance Agreement."

The Authority also observed that paragraph (3) of article 4 contemplates not the location of a place of effective management generally but the location of the place of effective management as between the two Contracting States entering into the double taxation avoidance agreement.

In *Union of India v. Azadi Bachao Andolan* [2003] [263 ITR 706](#) (SC), the Supreme Court observed:

"The DTAC requires the test of "place of effective management" to be applied only for the purposes of the tie-breaker clause in Article 4(3) which could be applied only when it is found that a person other than an individual is a resident both of India and Mauritius. We see no purpose or justification in the DTAC for application of this test in any other situation."

In another case [*AAR No. p. 10 of 1966*, (1996) [89 Taxman 125](#) (AAR) *In re*, decided on the 14th August, 1996], it was urged before the Authority for Advance Ruling that the applicant companies were subsidiaries of the American company and their shareholders are other companies (also the subsidiaries of the same company) with registered office in different countries and that though they have some Mauritians as directors but the real and effective management comes from the location of the American company or other shareholding companies, say USA or Hong Kong or the like. The Authority found that the investor company (the applicant before it) had its registered office in Mauritius and its only transaction is the investment in India. In an application made in January, 1996 to the Mauritius Offshore Business Activities Authority (MOBAA) for residency certificate, certain features of the investor company showed that its effective place of management was in Mauritius. It showed that the following steps were to be taken to ensure Mauritian place of management in particular:

1. The company has two resident directors of appropriate calibre to exercise independence of mind and judgment;
2. The company's secretary is resident in Mauritius;
3. The registered office is in Mauritius;
4. Banking transactions would be channelled through Hong Kong and Shanghai Banking Corporation;
5. Accounting records would be maintained in Mauritius in accordance with the Companies Act, 1984;
6. Board meetings would be held in or chaired from Mauritius;
7. All statutory records such as maintained and members' register, would be kept at the registered office;
8. The company would have an ordinary status.

In view of the above the Authority for Advance Ruling rejected the contention that the effective management did not reside in Mauritius. It observed as follows:—

"Firstly, it is difficult to say that the effective management of the affairs of the company is not in Mauritius in the above situation unless there are facts to at least *prima facie* indicate that such control emanates elsewhere than from Mauritius...Secondly, in its ruling reported as *AAR No. P-9 of 1995, In re*, the Authority has pointed out that article 4(3) is intended to break the tie on the issue of residence as between the two Contracting States. The companies are, on article 4(1), resident both in India and Mauritius and under article 4(3), the seat of effective managements as between the two Contracting States, should be taken to be in Mauritius. Article 4(3) does not authorise the exploration of a possibility that the effective management, despite the company's location and residence in Mauritius, could lie elsewhere in a third country. The Authority would therefore, hold that the investor-company is resident of Mauritius entitled to claim the benefit of the DTAA."

In the same ruling the Authority had found that the investment manager had agreed to provide and be responsible for the day-to-day management and the administrative services to the trust fund and any directions of the trustees.

Residence of a company - Generally

10.17 A company normally resides at a place where the central management and control actually abides - *De Beers Consolidated Mines Ltd. v. Howe (Surveyor of Taxes)* [1906] AC 455 (HL), irrespective of the fact where business operations are carried on. The place of business operations and the place of central management and control may or may not coincide. The place of registration or incorporation of a company is not conclusive of the place of residence - *Cesena Sulphur Co. Ltd. v. Henry Nicholson* [1876] 1 Ex. D. 428, *Calcutta Jute Mills Co. Ltd. v. Henry Nicholson* [1876] Ex. D. 428, *Egyptian Delta Land & Investment Co. Ltd. v. Todd (Inspector of Taxes)* [1929] AC 1, *Malazan Shipping Co. Ltd. v. FCT* [1946] 8 ATD 75 and *De Beers Consolidated Mines Ltd. v. Howe (Surveyor*

of Taxes) [1906] AC 455 (HL), though the place of registration may be a factor in deciding where the control is *Swedish Central Railway Co. Ltd. v. The Thompson* [1925] AC 495. In order to determine whether a company is resident in one place or in another the registered office is an incident of evidence - *New Zealand Shipping Co. Ltd. v. Thew* [1922] 8 TC 208. But one has to find out what is the chief seat of management and the centre of trading of the company in order to ascertain what is the real residence. The real test for residence of the company is, therefore, where the 'control and management' abides and the question which abets is, where does it reside.

Residence of a company - Control, meaning - Meaning of 'Control' Residence of a company - Control, meaning - Meaning of 'Control'

10-17-1 The 'control' does not mean control of the company by means of voting power, but control in relation to company's business. The shareholders can, no doubt, by virtue of their votes, control the corporation. They can compel the directors to do their will. It does not, however, follow that the corporators are managing the corporation. The contrary is the truth, they are not. It is the directors who are managing the affairs of the corporation - *American Thread Co. v. Joyce (Surveyor of Taxes)* [1913] 6TC 163 (CA). The real business is carried where the directors exercise their control over the company's affairs—*Egyptian Delta Land & Investment Co. Ltd. v. Todd (Inspector of Taxes)* [1929] AC 1. However, even the dictum that the real business is carried on where the central control and management abides is not free from doubt. The House of Lords in *Bullock v. Unit Construction Co. Ltd.* [1959] 38 TC 12 (HL), held that the place of central management and control is to be determined on the facts of each particular case and the location of the directors and the directors' meetings would only be conclusive where they actually exercise the highest level of control of the business of the company. In this case the residence of the subsidiary company was determined by reference to the residence of the parent company which took over the management and control of the subsidiaries from the locally based (overseas) directors.

Residence of a company and the Income-tax Act Residence of a company and the Income-tax Act

10.17-2 The Income-tax Act provides in section 6(3) that a company is said to be resident in India in any previous year if (a) it is an Indian company, or (b) during that year the control and management of its affairs is situated wholly in India. The expression 'Indian company' has been defined in section 2(26). It means a company formed and registered under the Companies Act.

If a company is registered in India or is otherwise an Indian company, it is always to be deemed resident of India, even if its control and management abides abroad. The doctrine of the 'control and management' and the criterion is laid in *De Beers Consolidated Mines Ltd. v. Howe (Surveyor of Taxes)* [1906] AC 455 (HL). What is given the statutory recognition for determination of the residential status, becomes applicable only if a company is not an Indian company within the meaning of the Indian Companies Act. As a result of the provisions of the Companies Act and the Income-tax Act, a company must inevitably and always be resident at its registered office. Thus a company regulated by the Companies Act has a residence (though not necessarily a sole residence) analogous to the residence of an individual, at its registered office. This, however, does not mean that there are two tests for establishing the residential status, one, for the foreign companies, i.e., the place of control, and another for the Indian companies, i.e., the place of incorporation. The same principle should be applied to all companies, namely they are residents where central control is situate. If this test is uniformly applied, a company registered in India could yet be non-resident. The Legislature contemplated this situation and therefore gave Indian residential status statutorily, if a company is registered in India.

There could be a situation that an Indian company could be resident abroad because of the existence of the control and management there as well resident of India because of its incorporation here. Such a company enjoys dual residence. The concept of dual residence as applicable to companies is analogous to the concept as applicable to individual. Like an individual, the company could reside in two places at the same time—*Swadeshi Central Railways Co. Ltd. v. Thompson (Inspector of Taxes)* [1925] AC 495. In applying the conception of residence to a company, one should proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. It is, therefore, necessary to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in India. So may a company. Otherwise, it might have its chief seat of a management and its centre of trading in India, under the protection of Indian law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad. A company resides for purposes of income-tax where its real business is carried on. The real business is carried on where the central management and control actually abides—*De Beers Consolidated Mines Ltd. v. Howe (Surveyor of Taxes)* [1906] AC 455 (HL), *Calcutta Jute Mills Co. Ltd. v. Henry Nicholson* [1876] 1

Ex. D 428 and *Cesena Sulphur Co. Ltd. v. Henry Nicholson* [1876] 1 Ex. D 428, which sometimes has been stated in the form ‘head, seat and directing power’. The question depends on the fact of the management and not on the physical situation of the thing that is managed. A company is managed by the board of directors and if the meetings of the board of directors are held within India, it may be said that the central control and management is situated here. The direction, management and control ‘the head and seat and directing power’ of a company’s affairs is, therefore, situate at the place where the directors’ meetings are held and, consequently, a non-Indian company would be resident in this country if the meetings of the directors who manage and control the business are held here. The word ‘affairs’ means affairs which are relevant for the purpose of the Income-tax Act and which have some relation to the income sought to be assessed. It is not the bare possession of powers by the directors, but their taking part in or controlling the affairs relating to the trading, that is of importance in determining the question of the place where the control is exercised. They must exercise their power of control in relation to business or activity wherefrom the profit is derived—*Egyptian Hotels Ltd. v. Mitchell* [1915] 6 TC 542 (HL) and *CIT v. Bank of China* [1985] [154 ITR 617](#) (Cal.).

Residence of a company - Tie-breaking rule - Residence effective control Residence of a company - Tie-breaking rule - Residence effective control

10.17-3 In case of foreign companies, there could be duality of residence. A limited company can contemporaneously have more than one residence. The control and management can be divided. *Koitaki Para Rubber Estates v. FCT* [1940] 64 CLR 15 (an Australian case) and *Union Corpn. Ltd. v. IRC* [1952] 1 All ER 646 (CA). A company be controlled in two places. A company may do such acts within one country as causes it to be liable as resident to income-tax without excluding the possibility that it may also be held resident in another country for the same or another purpose—*Swedish Central Railway Co. Ltd. v. Thompson (Inspector of Taxes)* [1925] AC 495. The criterion for determination of the residence is to explore where the central management and control abides. The place to be searched for that purpose be not only where final and supreme authority over the company’s affairs resides. The central management and control of a company does not depend upon the power of the supreme command or final arbitrament but could be found wherever are not some substantial business operations in a given country, but directing power of the authority. Thus the company may be incorporated in a foreign country where its general meetings are held and its accounts kept and audited. The real and ultimate control over its activities and general policy is, decided by the majority of directors in another country, say India, where they reside. The minority meet in the foreign country who have no such final control. Since some part of superior and directing authority is found in the meetings of the directors (minority) in foreign country, the company can be said to have dual residence as its central management and control is divided.

The control and management could be divided and may abide in more than one place, could also be inferred from a reading of section 6(3) of the Income-tax Act. It says, *inter alia*, that a company could be said to resident in India in the previous year, if during that year, the control and management of its affairs is situated wholly in India. When the section refers to the control and management being wholly situated in India, it implies that the control and management can be situated in more places than one.

The word ‘wholly’ used in section 6(3) or in section 6(4) does not mean ‘exclusively’. When the section refers to the control and management of its affairs being situated wholly in India, it may mean power of the Supreme Command or final arbitrament.

There are three-tiers of the control of a company—

- ◆ Policy
- ◆ Management
- ◆ Administration

It is mainly with reference to the first that the control and management of the company’s affairs is spoken of. But some decisions and directions are also needed for the management and administration of the company’s day-to-day affairs and for that matter superior and directing authority has been vested in some of the minority of directors who reside at the place of business operations of the company, who have no final control, the exercise of such authority cannot be equated with the controlling and the directing power, the head and brain of the company.

As for India, in terms of section 6(3) the principles which could be culled up from those as established in England as enunciated in *Swedish Central Railway Co. Ltd. v. Thompson*, are as follows:

- ◆ The conception of residence in the case of a fictitious person, such as a company, is as artificial as the company itself, and the locality of the residence can only be determined by analogy, by asking where is the head and seat and directing power of the affairs of the company. Control and management signify the controlling and the directing power, the head and the brain as it is sometimes called, and 'situated' implies the functioning of such power at a particular place with some degree of permanence, while 'wholly' would seem to recognise the possibility of the seat of such power being divided into two distinct and separate places. As a general rule, the control and management of a business remains in the hands of a person or group of persons and the question to be asked is wherefrom the person or group of persons controls or directs the business.
- ◆ Mere activity by the company in a place does not create residence with the result that a company may be 'residing' in one place and doing a great deal of business in another.
- ◆ The central management and control of a company may be divided and it may keep house and do business in more than one place, and if so, it may have more than one residence.
- ◆ In case of dual residence it is necessary to show that the company performs some of the vital organic functions incidental to its existence as such in both the places, so that in fact there are two centers of management.

Different countries define "the place of management" differently. For example (*see* Report of Committee on E-Commerce) :

- in Australia courts define the "place of central management and control" as one where directors of the company exercise their power and authority;
- in Switzerland, "the place of effective management" is distinguished from the place where merely administrative decisions are taken;
- in Germany, the place of management is not where the management directives take effect but the place where these are given.

The common feature is the directing power of the authority which controls and directs the affairs of the company and the place where it resides. It is normally taken to be the place where directors meet, confer and decide. But in the present context of video conferencing, there is no need for the directors to meet at one place. Living or located in different countries, they can communicate simultaneously with each other and decide. In that situation, it is necessary to take into account other factors, such as—

- the place of incorporation,
- the place of residence of the shareholders and directors,
- the place where business operations take place,
- the place where financial dealings of the company occur, and
- the place where the seal and the minutes book are kept.

Where the State in which the effective management is situated cannot be determined, the competent authorities may settle the question by mutual agreement.

Residence of a foreign company in liquidation

10.17-4 The test to be applied for determination of the residence of a foreign company in liquidation is the same as for others, namely, where control and management of its affairs abide. The word 'affairs' means affairs which are relevant for the purposes of the Income-tax Act and which have some relation to the income sought to be assessed.

Under section 449 of the Companies Act, on winding up order being made in respect of a company, the official liquidator shall, by virtue of his office become the liquidator of the company. Under section 178 of the Act, every liquidator of a company which is being wound up, whether official liquidator, provisional liquidator or others, must within 30 days of his becoming a liquidator give notice of his appointment to the income-tax authority who is entitled to assess the income of the company. Section 456 of the Companies Act provides that upon the appointment of a liquidator, he becomes the custodian of the company's property. The company's assets are to be treated as being in the custody of the court. Although under rule 233 of the Companies (Court) Rules, 1959, the position of the official liquidator is the same as that of the receiver but the property of the company does not vest in him as in the case of the official assignee on a insolvent's estate. The property of the company continues to vest in

the company itself and on the winding-up order, all the properties and effects of the company will be *custodia legis*. Section 457 of that Act enumerates the powers of the official liquidator. Section 491 of the Companies Act provides that on the appointment of a liquidator, all the powers of the board of directors, and of the managing or whole-time directors and manager, if there be any of these, shall cease. The position of the official liquidator is essentially that of an agent employed for the purpose of the winding-up of the company. The Supreme Court in the case of *Hari Prasad Jayantilal & Co. v. V. S. Gupta, ITO* [1966] [59 ITR 794](#), has observed that the property of the company does not vest in the liquidator; it continues to remain vested in the company. On the appointment of a liquidator, all the powers of the board of directors and of the managing or whole-time directors, managing agents, secretaries and treasurers cease (section 491) and the liquidator may exercise the powers mentioned in section 512, including the power to do such things as may be necessary for winding-up the affairs of the company and distributing its assets. The liquidator appointed in a members' winding-up is merely an agent of the company to administer the property of the company for purposes prescribed by the statute. In distributing the assets including accumulated profits, the liquidator acts merely as an agent or administrator for and on behalf of the company.

For the purpose of winding-up, foreign companies are treated as unregistered companies. Section 582(b) of the Companies Act provides that an unregistered company will include companies incorporated outside India. Section 583 of the Companies Act provides for the winding-up of an unregistered company. All the provisions of the Companies Act with respect to winding-up shall apply to an unregistered company with the exceptions and additions mentioned in sub-sections (2) to (5) of section 583. Therefore, upon the winding-up of the foreign company, the board of directors ceases to exist in terms of section 491 of the Companies Act. The liquidator exercises the powers and discharges the duties and enumerated in section 457 and rule 232 and rules 270 to 280 of the Companies (Court) Rules, 1959.

The liquidator exercises certain powers with the sanction of the court, but all the powers exercisable by him under section 457 of the Companies Act are subject to the control of the court. Sanction of the court may be obtained before or after the exercise of power. If the court, however, does not accord sanction, the exercise of the power by the liquidator will have no effect at all. The company court exercises control over that acts and deeds of the liquidator and the method and manner of exercise of power by the liquidator. The control and management of the affairs of the company in liquidation vests in the liquidator, who is only empowered to do all acts and deeds for winding-up the affairs of the company subject to sanction and/or control of the court.

If a foreign company has sources of income situated in India, and has undergone in liquidation, the affairs relating to earning of such income is controlled and managed in India by the official liquidator. By virtue of the provisions of the Companies Act, the liquidator has not the right or power to control and manage the affairs of the foreign company in liquidation. Thus, a company in liquidation must be deemed to be resident in India, in terms of section 6(3) - *CIT v. Bank of China* [1985] [154 ITR 617](#) (Cal.).

Residence of an entity other than individual - Income-tax Act

10.18 Section 6 of the Indian Income-tax Act, 1961 deals with residence of an individual at one end and of a corporation like the company at the other. It also deals with residence of three entities, viz., Hindu undivided family, firm and association of persons. The tests for the three categories are different. Special tests have been provided for individuals, based on residence for a certain number of days. Two alternative tests have been provided for companies; the first being that the company is Indian and the other, that the control and management of its affairs is situated wholly within India. The tests for the Hindu undivided family, etc., is reversed which is non-resident only if the whole of its control and management is situated without India.

Residence of entity other than company - Control and management

10.18-1 The words 'control and management' have been figuratively described as 'the head and brain'. In case of individual this test is not necessary because his residence for a certain period is enough; it being clear that within the taxable territories he would necessarily bring his 'head and brain' with him. The 'head and brain' of a company is the board of directors, and if the board of directors exercises complete local control, then the company is also deemed to be resident. In the case of Hindu undivided family, firm, association of persons, the control and management can be exercised by one or more of the group. So long as control and management (even partly) is found, such person may be treated as resident. The expression 'control and management' means *de facto* control

and management and not merely the right or power to control and manage. —*Bhimji R. Naik v. CIT* [1946] [14 ITR 334](#) (Bom.) and *CIT v. Nandlal Gandadal* [1960] 40 ITR 1 (SC).

Residence of entity other than company - Control and management tests

10.18-2 The necessity for the test is obvious. The income-tax law anticipated that the control and management of the affairs of a group of persons might easily be in two or more places, one or more members being within India and the other or others, without. To prevent the escapement of tax and to get at the income of such persons having multiple places of control and management, it was provided that the whole of the control and management must be without India to avoid the implication of residence. Otherwise, different members can manage different business in India and the person, say a Hindu undivided family cannot be regarded as resident if the karta lived outside, an anomaly which does not arise.

Residence of entity other than company - Affairs, meaning

10.18-3 The word 'affairs' must mean affairs which are relevant for the purpose of Income-tax Act, and which have some relation to income—*V. VR. N. M. Subbayya Chettiar v. CIT* [1951] [19 ITR 168](#) (SC). It refers to an activity resulting in the making of income. The word 'wholly' suggests that a Hindu undivided family may have more than one residence in the same way as corporation may have.

If the control and management is wholly or partly situated in India, the assessee be treated as resident of India. Even if a part of the control and management be it even very small a part, is exercised in India, the provision is satisfied. It is difficult to locate the situs of the control and management. The expression 'its affairs' calls for an attempt to trace the assessee's place of control and management.

The expression "Control and management" is used in section 6 of the Income-tax Act, 1961 in relation to the affairs of the company. In the double taxation agreement it is used with reference to business. The expression "affairs" is wider than "business"—*Universal Cargo Carriers Inc. v. CIT* [1994] [205 ITR 215](#) (Cal.)

Residence - Investment funds

10.18-4 For an investment fund to have treaty access, the conditions to be satisfied are (1) persona, (2) residence, and (3) beneficial ownership. As regards the first the matter has already been discussed; as regards to (3) it is done later. A fund must be resident to one or both of the contracting states, liable to tax in a contracting State by reason of any of the provided criteria, *i.e.*, place of management or any other criterion of similar nature. Under the Indian Income-tax Act, 1961, income of the overseas financial organisation (offshore fund) and of the foreign institutional investors is taxable (*see* sections 115AB and 115AD). Thus, India regards the fund as an entity liable to tax. It is a person for the purpose of tax treaty.

Residence of a Hindu undivided family - Control and management

10.19 In case where the Hindu undivided family or its karta controls and manages business in the territories of India no difficulty arises. But where the family is represented by one of its coparceners as partner in a firm, one faces some difficulty. Two questions may arise :

- ◆ Is there any 'affair' of the Hindu undivided family in India in such circumstances?
- ◆ Is the fact that the coparcener controls and manages the partnership wholly or partly, sufficient to enable one to say that the control and management of the family is located in India?

It is a settled law that a Hindu undivided family cannot be partner under the law of partnership. Such of the coparceners who join the partnership are regarded quoad the other partners, as individuals in their own names and rights. Yet, the benefit that arises to them from the partnership belong to the family, and their rights are assets of family—*Charandas Haridas v. CIT* [1960] [39 ITR 202](#) (SC). In such a situation the matter has to be looked at in the light of three separate and independent branches of law. They are the law of partnership, the Hindu law and the law relating to income-tax. The implications of a coparcener joining as partner with strangers are different when one views the matter from the angle of the law of partnerships or from the angle of the Hindu law or from the law of income-tax. Insofar as the law of partnership is concerned, the coparcenary has no place in the partnership and

the coparcener partner is everything. But, viewed from the angle of Hindu law, the position is entirely different. Two principles have to be borne in mind in this regard. The one is, according to true notion of an undivided family in Hindu law, no individual member of that family whilst it remains undivided can predicate of the joint and undivided property, that he, that particular member, has a certain definite share. The proceeds of an undivided property must be brought, according to the theory of an undivided family, to the common chest or purse, and then dealt with according to the modes of enjoyment by the members of an undivided family. And the second is; there is community of interest and unity of possession between all the members of the family, and upon the death of any one of them the others may well take the survivorship that in which they had during the deceased's lifetime a common interest and a common possession.

There are other principles also, as, for example, the right of a coparcener to claim a partition, or where such usage obtains, to alienate his interest, which gives rise to the expression that a coparcener has a share. In point of Hindu law, however, a coparcener cannot claim any item of property or even a share of it as his own, and his dealings with the assets are, insofar as he is concerned, for the benefit of the family. The law of income-tax makes the sole test for purpose of residence of a Hindu undivided family the existence of 'affairs' and its control and management even partly in India. It is thus plain that whilst in the eye of the law of partnership the coparcener who is co-partner is everything, in the eye of the Hindu law he is no more than a member of a body of owners. The word 'affairs' means the affairs of a Hindu undivided family which are capable of being controlled and managed by the family as such and so where a coparcener enters into partnership with strangers, the Hindu undivided family exercises no controlling power of the management over the partnership— *CIT v. Nandlal Gandadal* [1960] 40 ITR 1 (SC).

Residence of a person - India's approach in a tax treaty

10.20 India's approach to resident article is to follow the UN model. There are, however, some variations in individual cases.

Residence of a person - Australian tax treaty

10.20-1 For the purpose of the tax treaty, a person is the resident of the state if he is resident for the purposes of its tax. He is not so to be, if he is liable to tax in respect of only of income from sources in that state. Availability to him a permanent home in and, thereafter, closeness of personal and economic relations with, the state are the rules to break the tie. The factors to be taken into account for determining the said closeness are the citizenship as well as habitual abode.

Residence of a person - Canadian tax treaty

10.20-2 With respect to residence of a person other than the individual, the place of effective management is not the criterion. The competent authorities decide the matter by mutual agreement. In the absence of such an agreement, the person is not considered to be a resident of either of the states for the purpose of the treaty benefits.

Residence of a person - Japan tax treaty

10.20-3 The treaty does not provide any rule. The competent authorities determines the matter by mutual agreement.

Residence of a person - USA tax treaty

10.20-4 Other than the four criteria provided in the model, the two more added are the citizenship and the place of incorporation. With respect to income derived or paid by partnership, estate, or trust, person is a resident of a contracting state only to the extent that the income thus derived is subject to tax in that state as the income of the resident, either in its hands or in the hands of its partners or beneficiaries. The expression "resident of a Contracting State" does not include any person who is liable to tax in that state in respect only from sources in that state. The above criteria *viz.*, the place of management or place of incorporation with exceptions are also applicable to a company. If found to be resident of both the states, it is to be considered outside the scope of the tax treaty except for purposes article 10(2) (dividends), article 26 (non-discrimination) article 27 (mutual agreement procedure), article 28 (exchange of information and administrative assistance) and article 30 (entry into force).

For a person other than an individual or a company which is found to be resident both the Contracting States, their competent authorities settle the matter by mutual agreement and determine the mode of application of the treaty to such person.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - PERMANENT ESTABLISHMENT

ARTICLE 5

PERMANENT ESTABLISHMENT

1. *For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*
2. *The term "permanent establishment" includes especially :*
 - (a) *a place of management ;*
 - (b) *a branch ;*
 - (c) *an office ;*
 - (d) *a factory ;*
 - (e) *a workshop ;*
 - (f) *a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*
3. *The term "permanent establishment" also encompasses:*
 - (a) *a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last for more than six months ;*
 - (b) *the furnishing of services, including consultancy services, by an enterprises through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any 12-month period.*
4. *Notwithstanding the preceding provisions of this article the term "permanent establishment" shall be deemed not to include :*
 - (a) *the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise ;*
 - (b) *the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display ;*
 - (c) *the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ;*
 - (d) *the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise ;*
 - (e) *the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.*
 - (f) *the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e), provided that overall the activity of the fixed place of business resulting from the combination is of preparatory or auxiliary character.*
5. *Notwithstanding the provisions of paragraphs 1 and 2, where a person— other than an agent of an independent status to whom paragraph 7 applies— is acting, in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person :*

- (a) *has and habitually exercises in the State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph ; or*
 - (b) *has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.*
6. *Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to reinsurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.*
7. *An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and the conditions are made or imposed between the enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises; he will not be considered an agent of an independent status within the meaning of this paragraph.*
8. *The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise) shall not of itself constitute either company a permanent establishment of the other.*

IntroductionIntroduction

11.1 Article 5 is the definition article, and defines the expression "Permanent Establishment" (PE). The business profits of an enterprise of other Contracting State can be taxed if it carries a business through a permanent establishment. The concept makes a distinction between doing business in or with a country, as discussed in Chapter I. A taxpayer is generally taxed on its world wide income in the country of its residence. It can also be taxed in another country if it has recognised source of income there. Double taxation results. To avoid so happening tax treaties make a compromise. They restrict application of domestic source rules. The taxation of business income on the basis of source rule requires in the country of source some business presence. Such presence is known as permanent establishment (PE). Thus, the historical origin of the concept of PE is a compromise between the countries that favoured the principle of residence and the countries that favoured the principle of source. The basic rule of the PE is that it represents physical business presence. Paragraph 1 sets out a general definition, as a fixed place through which business of an enterprise is carried on. It is sometimes referred to as the basic rule. Paragraph 2 gives an inclusive definition, defining the type or nature of place. Paragraph 3 prescribes a limitation. It is a further extension of the inclusive definition which is made subject to a qualification based on period of continuance. This does not extend the scope of the definition in the earlier paragraphs. Paragraph 4 outlines a number of exclusions. Paragraphs 5 to 7 deal with special cases where the foreign enterprise functions not directly but through some other agency in the relevant territory. Paragraph 8 provides that a controlled company by itself does not constitute a permanent establishment.

The definition of "permanent establishment" is also of relevance, as the expression is found in other articles of the convention. For taxation of business profit under article 7, it is necessary for the permanent establishment to exist. "Fixed base" under article 14 (Independent Personal Services) is understood to have a meaning akin to "permanent establishment". For reduced rates of withholding tax on payments of dividends (article 10), interest (article 11), and royalties (article 12), to the residents of the other Contracting State, it is necessary that such income is not effectively connected to a permanent establishment or fixed base of the recipient. The concept is also relevant in determining which Contracting State may tax certain gains under Article 13 (Capital gains), certain "other income" under Article 21 (Other income), and certain capital under Article 22 (Capital). The concept is also relevant for Article 24 (Non-discrimination).

The definition covers all economic activities *i.e.*, mining and farming, manufacturing, services, and, commercial, with some exceptions which are dealt with separately under various other articles, such as business of shipping, professional or dependant services, royalties, etc. For the allocation of jurisdiction to the source state, the income should be attributed to the PE in that State. PE taxation deals with extractive industries, manufacturing enterprises

and commercial establishments, *i.e.*, with all significant industries, excepting shipping and airways dealt with under article 8. The PE concept emphasises permanence of geographical place of business activity. Permanence test and in some cases duration test determine whether the establishment is a PE.

Permanent establishment - Effect

The notion of permanent establishment is the core of the Double Taxation Agreements. It primarily decides taxing jurisdiction over business activities of the States who could legitimately lay claim on income arising therefrom, independently of the taxpayer's residence or the "source" as in case of other categories of income (dividend, interest, royalty, or capital gains). The other effects of secondary importance are—

- ...■ Investment income if connected to PE is treated as business income and not as dividend, interest, royalty, or capital gains;
- ...■ If the remuneration etc. of an individual exercising employment in other State is borne by the PE of the employer, the "183-day rule" does not apply, *i.e.*, the remuneration would be taxable in the State of PE irrespective of the duration of stay;
- ...■ If an enterprise has PE, it is protected against tax discrimination.

The definition of PE as given in paragraph 1 is sometimes referred to as the basic rule and applies to business activity of 'permanence' with physical location, in other jurisdiction.

Permanent establishment - UN Model and the OECD Model - Comparison

11.2 The UN Model and the OECD Model differ with respect to the following:—

- Paragraph 3 of the UN/OECD model is an extension of paragraph 2 prescribing a limitation with regard to a period of continuance, before a place as listed in paragraph 2 could be taken as PE. In UN Model it commences with the expression "The term permanent establishment encompasses" (The OECD Model does not introduce the paragraph with such expression, but instead states that it "constitutes"), and is divided into two parts. Part (a) refers to continuance of site, project and activities for a period of more than six months, (The OECD model refers to site or project and not the supervisory activities in connection therewith, and the period, instead of six months, is twelve months). Part (b), also holds furnishing of services as permanent establishment. The OECD Model does not so hold.
- The UN Model excludes "delivery" from the exclusion from PE under Article 5(4) of the OECD Model.
- About the activities of the agent as constituting permanent establishment, the OECD Model definition just states the general position. The UN Model goes further and adds, "when the activities of such an agent is devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph" (*see* paragraph 7 of the UN Model). It also states that even where an agent "has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise" permanent establishment may be inferred (sub-paragraph 5(b) of the UN Model)
- Paragraph 6 of the UN Model deems an insurance enterprise of a Contracting State to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other Contracting State or insures risks situated therein through a person other than an agent of an independent agent.
- Article 5(7) of this UN Model does not appear in the OECD Model. It provides that to determine the status of agent, it is necessary to take into account the entirety of the commercial & financial relations between the enterprise and the agent.

Permanent establishment - Definition import restrictive and expanding

11.3 The definition consists mainly of two parts. One is introduced by the expression "means", and thus, restrictive; and the other, by "includes", and thus clarificatory and expanding. There are also exceptions which are introduced with the expression "deemed not to include". A combined reading of paras 1 to 8 of article 5 brings out the import of the expression "permanent establishment". Whereas para 1 defines the expression to mean a fixed place of business through which a business of an enterprise is wholly or partly carried on, para 2 enumerates six places specified in clauses (a) to (f) to include them within the scope of the expression and para 3 extends the meaning

beyond "place" to include building sites, installation project, furnishing of services etc. Para 4 which commences with a *non obstante* clause contains a deemed exclusionary clause to exclude the use of facilities noted in clause (a), maintenance of stock of goods mentioned in clauses (b) and (c) and maintenance of a fixed place of business for purposes indicated in clauses (d), (e) and (f) from the scope of the expression despite the provisions of paras 1, 2 and 3. However, para 5 contains a deemed inclusion clause. It also commences with a *non obstante* clause and says that notwithstanding the provisions of paras 1 and 2, a person acting in a Contracting State on behalf of an enterprise shall be deemed to have a permanent establishment in the first mentioned State, if any one of clauses - (a) or (b) thereof - applies. Clause (a) deals with a person who has and habitually exercises authority to conclude contracts on behalf of the enterprise in the first mentioned State unless the activities are limited to the purchase of goods or merchandise for the enterprise ; and clause (b) deals with a person who acts without authority, but habitually maintains a stock of goods or merchandise in the first mentioned State from which he regularly delivers them on behalf of the enterprise. Para 6 also commences with a *non obstante* clause and says that an insurance enterprise shall be deemed to have a permanent establishment if it collects premiums in the territory of another Contracting State or insures risks situated therein through a person other than an agent of an independent status to whom para 7 applies. Para 7 incorporates a deemed exclusion clause and says that an enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in the other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of business. Nonetheless when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the conditions are made or imposed between the enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises (*i.e.* , both are controlled by the same interest), he shall not be considered as an agent of an independent character. Para 8 says that the fact that a company controls or is controlled by the other enterprise or which carries on business in the other State shall not by itself constitute a company or permanent establishment of that other company.

The expression "permanent establishment" has been defined with reference to a place and a person. With respect to a place it is restrictive, clarificatory and expanding. With respect to a person, it is deeming. Fixed place of business though which the business of an enterprise is carried on wholly or partly is the basic requirement. This is fixed place PE, or the basic rule PE which may include premises, facilities or installations, as to make it possible to locate, identify or point out to definite place as the place from which business is carried on. There is construction PE *i.e.*, building site, a construction, assembly or installation project, if it lasts for more than a specified period. Both these have reference to a place. There is a service PE (which finds place in the UN Model), where an enterprise renders services through its employees provided services are rendered for a specified period. There is another type, which has reference to a person. It is agency PE *i.e.*, a person acting as an agent for foreign enterprise. Thus, presence of physical object, right to use with somewhat permanence and the business activity or connection are the determinative tests.

Permanent establishment is the non-resident business presence. The degree of presence which could constitute PE has been illustrated by inclusion and exclusion. A non-resident conducts business in another country through a branch or agency. A "branch" connotes a physical presence when he employs staff to carry on business. Plant and equipment used in connection with a construction project could constitute a branch. A vending machine could constitute a branch. A server could constitute a branch. All these are so taken because they perform some functions that would amount to a business activity. In all these, staff is posted to operate or maintain.

An "agency" does not require physical presence. It, however, requires a relationship with the "agent" on whom contract-making authority is bestowed. Instead of having an office as branch and employing staff to carry on business, the non-resident appoints a local agent to carry on the business.

Branch or agency is treated as if it were a separate company and the profits attributable to it is taxable in the country of its existence.

Permanent establishment - Value-creating activitiesPermanent establishment - Value-creating activities

11.3-1 The import of the definition of "permanent establishment" is that an enterprise is liable to tax on its profits in a foreign country if it carries out its business activities in that country provided such activities do not merely take the form of isolated or occasional transactions or are of not preparatory or auxiliary in character. There should be continuity of activities contributing to the earning of income, something more than mere transaction of purchase and sale and are of not preparatory or auxiliary in nature. Such activities must be value-creating activities requiring

capital and labour. The concept of PE renders an enterprise liable to taxation on its profits in a foreign country by providing criteria to determine whether the enterprise or its agents actually conduct core business income producing activities in the foreign country which are not of preparatory or auxiliary in nature. The conduct of such activities normally requires the enterprise to have some physical presence in the foreign country, by way of labour or property.

The concept of value-creating activities of a foreign enterprise and taxability of income attributable to such activities is rooted to the concept of doing business "in" a country or "with" a country. Economic nexus is an important aspect of the principle of profits attributable to PE (*see DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) (SC)). The PE concept helps establish what constitutes trading "in" a country in contrast to trading "with" a country from outside. For example, a company which is primarily concerned with the marketing its products and exports to other country on FOB basis as a result of orders solicited solely by advertising from its own country is obviously trading with another country. For the purpose of advertising or soliciting orders, it may maintain stock of goods or merchandise for storage or display. Similarly, for the purpose of purchase, it may have place for collecting information. If the company sets up a branch or a factory in another country, it is undoubtedly trading "in" that country. It cannot also be said to be trading "in" if sells goods or services through an independent agent or broker in the ordinary course of business. Trading "in" a country would mean carrying activities which are of productive nature and have the effect of adding value of the enterprise as a going concern.

There should be a fixed place of business which must have a productive character, *i.e.*, contributing to business earnings. Mere presence of establishment is not enough; it must contribute to the business earning. If it does not contribute, it would not be a permanent establishment, such as information bureau, storehouses, purchasing offices, advertising displays and showrooms where no goods are sold. Similarly, a company represented in the foreign country by means of a broker or an agent, and conducting its business on arm's length basis with an independent agent in the ordinary course of business, cannot be said to have a permanent establishment. However, where the relationship becomes so close that agent cannot be said to be independent, permanent establishment can be said to be existing. The value creating activities may be carried by the enterprise itself or through its agents who is not legally and economically independent. An agent is not considered independent, if—

- he habitually acts in the name of the enterprise and enters into contracts on its behalf;
- habitually transacts business on its accounts ;
- maintains stock of goods under his control for sales.

There is thus a distinction between dealings through an independent agent and dealings through a permanent establishment or a branch. A foreign enterprise is not liable to income-tax if its operations in the country are exclusively carried out through a broker, commission agent or other agent of an independent status.

Permanent establishment - Meaning

11.4 The permanent establishment as defined in para 1 of article 5 means a fixed place of business through which business of an enterprise is carried on. The definition requires performance of business activity through a fixed place of business in another country. That activity should be income generating and not auxiliary or preparatory, which is distinguishable from other activities of personal in nature (independent or dependent personal services) or activities relating to investments, patents, technical know-how etc., for which there are separate provisions. The only exception of business activity which is not covered under the PE definition is the activity of transportation through ships or aircrafts. The preposition "through" connecting the expression "fixed place of business" with "the business of an enterprise carried on" suggest that there must be connection between the business activity and the fixed place of business. Permanent establishment postulates the existence of a substantial element of an enduring and permanent nature of a foreign enterprise in another country which can be attributed to fixed place of business in that country and it could be of such a nature that it would amount to a virtual projection of a foreign enterprise of a country into the soil of another. It has, therefore, been defined in article 5(1) with reference to the fixed place of business.

All these are discussed in the following paragraphs

It generally takes the form of a branch, an office, facility, a construction site, or an agency relationship; but does not include storage facilities, the maintenance of inventory, a facility simply for the purchase of goods, or any activity of a preparatory or auxiliary nature. Permanent establishment has been generally defined in all Indian treaties.

When a tax treaty speaks "permanent home" in article 4(2) and "permanent establishment" in article 5(1), it does not really talk of an everlasting or eternal place of residence or business. Baker has pointed out (Double Taxation Conventions and International Tax Laws: Second Edition, p. 142, citing Du Park L.J.'s dictum in *Henriksen v. Grafton Hotel Ltd.* [1942] 2 KB 184 at 186) that a "permanent" is relative term which is not synonymous with "everlasting". The expression "permanent" is used in contradistinction to something fleeting, transitory, temporary or casual. The context in which the expression "permanent" is used in article 5 amply makes this clear. Paragraph 2 and paragraph 3 of article 5 indicate that the duration of the establishment need not be for years but may even be of months only. The words "permanent" and "establishment" when read with the language of paragraph 1 of article 5, connote the existence of a substantial element of an enduring or permanent nature which can be attributed to a fixed place of business in that country. Whether the nexus can be said to be "substantial" or "enduring" depends entirely on the facts of the case—*Advance Ruling P. No. 24 of 1996* [1999] [104 Taxman 377](#) (AAR - N. Delhi).

There must exist a place of business, which is fixed and through which business wholly or partly is carried on.

The expression "fixed place of business" means that the enterprise—

- ...■ must have a place of business;
- ...■ through which the business is wholly or partly carried on ; and
- ...■ it is available with a certain degree of permanence; which
- ...■ is fixed in the sense of having a distinct geographical location

Permanent establishment - Basic rule

11.4-1 The basic test of a permanent establishment is contained in paragraph 1 of article 5 which defines the expression as a:—

1. fixed place of business through which the business of an
2. enterprise is
3. wholly or partly carried on.

The first part of article 5(1) postulates that the existence of a fixed place of business whereas the second part postulates that the business is carried out through a fixed place. If the second part is not attracted, there is no PE [see *DIT v. Morgan Stanley* (2007) [292 ITR 416](#) (SC)]. There should be a fixed place of business through which the enterprise must conduct business activity and that activity must be income generating

The words "fixed place of business through which the business is carried on" postulates three tests for determining whether place of business qualifies as PE:

- ...■ *Business connection test* - The enterprise must conduct the business activity through the place of business;
- ...■ *Business activity test* - The activity must be an income generating business activity, and not merely preparatory or auxiliary.
- ...■ *Fixed place of business test (location test)* - There must be a link between it and a specific geographical point.

The expressions "place", "fixed", "through" and "business" have not been defined. These and the tests are discussed in the following paragraphs.

Permanent establishment - "Place" of business

11.5 Paragraph 1 is very concise as to what the expression "permanent establishment" connotes as meaning a fixed place of business through which the business of an enterprise is carried on wholly or partly.

The expression "place of business" is not defined in the Model Convention. Paragraph 1 of article 5, however, postulates the basic rule, followed by (paragraph 2) a list of specific examples of places which are *prima facie* PE. An "office", a "factory", a "workshop", or a "mine" are the places of business and not the PE. They would be PE if the business is carried through them. The list is not exhaustive, as the expression "includes" suggests. The two of the terms, "a place of management" and "a branch" are the real examples of the PE.

The definition of fixed place of business presupposes both physical resources as well as personnel who assist the entrepreneur in the use and the implementation of the physical resources.

The "place of business" is basically related to territorial nature of the treaties to avoid double taxation. It has not been defined in the model convention. Its import has to be gathered from the provisions of article 5. The material

requirement of article 5 is "carrying on the business". The facility which helps doing, is the permanent establishment, whether it may be a premises, equipment or an agent. The two tests to determine whether a non-resident person is carrying on a business in a country are:

- where the sale contracts are made;
- place of operations from which profits arise.

The place where the contracts are made is the most important, though not conclusive, factor in determining the territorial situs of a business [see *Erichsen v. Last* (1881) 4 TC 422 (CA)]. If the sale functions are performed through equipment, the equipment may be the PE, for example, vending machine. If done through an agent, agent is the PE.

According to paragraph 4 of the OECD Commentary on Article 5, the term "place of business"

- covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose; for example, a pitch in a market place or a certain permanently used area in a customs depot (e.g., for the storage of dutiable goods);
- may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal; for example, business facilities of another enterprise, certain business premises or part thereof owned by the other enterprise constantly at the disposal of the enterprise.

Place of business, therefore, means installations such as premises or in some cases, machinery or equipment. There could be no much difficulty in ascertaining place of business in respect of tangible goods. Difficulty arises when the transactions are done electronically, i.e., determination where the binding contract has been concluded (discussed later).

"A place", says Klaus Vogel at page 205 of his "Double Taxation Conventions", "though normally a particular portion of space, must be read here in the light of its being used to define 'establishment'. 'A place of business', therefore, means all the tangible assets used for carrying on the business; in marginal cases, one such tangible asset would be sufficient. The term covers both premises and other tangible assets used by the enterprise". Both premises and other tangible assets, therefore, constitute permanent establishment.

Arvid A. Skaar in his book Permanent Establishment observed:

"The concept of a 'place of business' in terms of PE can be defined as any substantial physical object which is commercially suitable to serve as the basis of a business activity. This includes real property, buildings, machines, computers, ships, aircraft, and drilling rigs. Consequently, securities, bank accounts, patents and software do not amount to place of business. The term 'place of business' also encompasses separate parts of the enterprise, such as foreign branches and places of management, but an office or similar fixed premises must be presupposed. Moreover, not all physical objects will be a 'place of business'. Light, portable equipment or machinery is not a PE - constituting place of business. In principle, animals (for example breeding animals) may be a place of business. Special provisions (the agency clause) apply to human being. A more precise impression of the objectivity of the PE is provided when the place of business is qualified as being connected to a specific geographical spot (the 'location test')."

The requirement of the place to be fixed postulates a link between the place of business and a definite geographical area or location. It envisages the possibility of locating, identifying or pointing out a definite place as the place from which a business is carried on. It is not the requirement that the place of business should be stationary and not moving. "To hold to the contrary", observed the Authority for Advance Ruling in *P. No. 24 of 1996* [1999] [104 Taxman 377](#) (AAR - N. Delhi), "would mean that, if an enterprise, say a dealer, were to carry on business of sale of merchandise in another State from a mobile van or a moving caravan, he would not be having a fixed place of business in the territory concerned. That does not seem to be the intention of describing a permanent establishment to include a fixed place of business." It further said:—

"Klaus Vogel says that the requirement that the place of business should be 'fixed' one postulates a link between the place of business and a specific geographical point. This would seem to be too narrow and restricted. The expression 'place' refers to a 'portion of space', as mentioned earlier, and it will be more appropriate to think of a 'fixed place of business' as postulating a link between the place of business and a definite geographical area or location; it would comprehend an area or range of functioning much wider than a

"dimensionless" point in space. The diving offshore vessel, in the case of the present applicants, located and functioning within a defined area, can well be described, in the Authority's view, as a fixed place of business from which they are carrying out their business."

The word "fixed" was explained in paragraph 5 of the OECD Commentary on Article 5 as "Thus in the normal way there has to be link between the place of business and the specific geographic point...." These words indicate the "location test" in a more liberal manner, as against the "distinct situs" test used in 1963 Commentaries. The word "normal" does not mean "invariable". Normally, and not invariably, there has to be a specific location. The word "geographical" refers to a region ; and "point" (according to *Webster's Collegiate Dictionary*) to a particular place, locality. The words "geographical point", therefore, convey a particular area in a jurisdiction and refer to performance of business activity in that area. The moving activity within a geographical area meets the requirement of "fixed place". There are some type of business which do not require specific location. A "geographical point" is not a point fixed to the soil. Movable place of business may constitute PE, e.g., construction activity, oil drilling rig, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand etc. The requirement of specific location is not necessary in case of unusual type where business is carried in a jurisdiction through a place which is not stationary. For example in a business of transportation through trucks involving delivery of goods in a specific geographical area, where the truck is a place through which business is carried and the link between it and the geographical point is provided by the space if available in that area for parking and maintenance.

The lack of specific spot may be compensated to some extent by the duration of the taxpayer's presence in the country, and the nature of the place of business. A movable activity within a delimited area meets the 'location test' under the basic rule if the activity has a short-term physical location and is regularly repeated at the same spots, or the work is commercially integrated as one project performed for one client (Arvid A. Skaar in his book *Permanent Establishment* observed at page 151, 1991 edition). The learned author concluded :

"The present writer's conclusion is that two trends have crystallized. Firstly, the conventional "base approach" of the OECD Commentaries, which requires a link to a specific geographical point, is still valid if the activity is conducted onshore for a relatively short period of time. Thus, no PE is constituted if the enterprise does not have a specific geographical location within the country for a period of for example 6 months in some relations, or as much as 12 months in others. Secondly, a continuous business activity (12 months or more) performed for one client, or on the account of the taxpayer himself, does not have to be located at a specific geographical point to constitute a PE. This applies in particular if the activity is performed at fixed temporary locations (for example drilling rigs). This reasoning is likely to apply to both onshore and offshore business activities, but it seems that practice concerning the offshore area is more persuasive at this point. Onshore business activities in this category may, however, in particular by the tax authorities in some countries such as Canada and Norway, be considered to constitute a PE."

Movable place of business may constitute PE if it has temporary fixed location. A PE machinery or equipment does not require a fixed place of business based on substantial use.

The place of business activities moving from one to other place is considered to exist where a particular location within which the activities are moved are identified as constituting a coherent whole commercially and geographically with respect to that business (*see* paragraph 5.1 of the OECD Commentary on Article 5) such as mining business, "office hotel", a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand (*see* paragraph 5.2 of the Commentary), or a contractor constructing road, dredging waterways or laying pipelines and thus relocating his activity continuously as the project progresses (para 20 of OECD Commentary article 5). There must be both commercial and geographical coherence for the moving business activities to be taken as single project and thus having a single place of business. If either is lacking, there is no single project or a single place of business. For example, for a painter working successively under a series of unrelated contracts for a number of unrelated clients in a large office building there is no single project for repainting the building, though the activities are carried within a limited geographic area (*see* paragraph 5.3 of the Commentary), or for a consultant working at different branches in separate locations pursuant to a single project for training the employees of the bank, there is a single project with commercial coherence but lacking necessary geographical coherence (*see* paragraph 5.4 of the Commentary).

Arvid A. Skaar in his *Commentary on Permanent Establishment* observed, "Thus, a movable activity within a delimited area meets the 'location test' under the basic rule if the activity has a short-term physical location and is

regularly repeated at the same spot, or the work is commercially integrated as one project performed for one client."

A permanent establishment is a virtual projection of the foreign enterprise of the country into the soil of another—*CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP). That projection does not require that the place of business should be stationary so long as it is possible to locate, identify or point out to a definite place as the place from which business is carried on. The only requirement is that that place should exist for some reasonable period sufficient to establish a nexus with the place of operation, so that it could be said "permanent" in an objective sense to be opposite to "for a limited period". The duration of the profit-making activities should not for a very short and very limited period.

The Authority for Advance Ruling - *Advance Ruling P. No. 24 of 1996* [1999] [104 Taxman 377](#) (AAR - N. Delhi), considered a question whether a fully diving support vessel brought within the territorial waters and functioning within the defined area to enable a foreign company to carry on its business within that territory could be considered fixed place of business in the territory and constituted a permanent establishment in India. The applicants have contended that their profits from these activities are not taxable as they have no permanent establishment situated in India. The Authority observed that there is no reason why the diving support vessel cannot be considered to be a fixed place of business it held:—

"Their business was to carry out under water operations for various purposes connected with oil wells and oil exploration, for purposes of extracting oil or providing for transport of the oil produced. These operations have to be carried out from a fixed base on board of a diving vessel; if that vessel is mobilised and brought into the territorial waters to enable the applicants to carry out their business within that territory, the applicants can, it seems to the Authority, be described as carrying on business through a fixed place of business in that territory."

In reaching the said conclusion, the Authority argued:—

"Suppose a dealer in certain goods stocks them on, and transacts his sales from the deck of a ship located in the territorial waters instead of from a shop located on land, there can be no difficulty in looking upon the ship as a place of business transacted in the like manner."

The Authority held the enterprise to be permanent establishment on other ground also. According to it, a place of business means both premises and other tangible assets used by the enterprise. The diving vessel fully equipped with all equipments satisfies this test.

Permanent establishment - Place of business covers premises, facilities and installations

11.5-1 The term place "place of business" covers any premises, facility or installation used for carrying on the business of the enterprise whether or not it is used exclusively for the purpose.

The place of business is the place of operations of business activities from which profits arise, which may take place from the territorial situs or may be performed through machinery or equipment or an agent. Thus a fixed place would mean both physical resources as well as personnel who assist in the use or implementation of those resources. Any tangible property whether building, facilities, industrial, commercial or scientific equipment or machinery may constitute a place of business. The place of business is a-

- premises or
- facilities or installations, or
- certain amount of space, or
- in certain instances, machinery or equipment.

11.5-1a PLACE OF BUSINESS PREMISE[BKMEND]S - "Premises" becomes applied to houses, lands, shops or whatever it may be so. The word has come to mean generally real property of one sort or the other. In the context of article 5, it may mean where goods are sold either by retail or wholesale or where services are rendered to customers, including an office, a store-room, godown, warehouse, or work place, a factory or a commercial establishment. It is a place where any business, or work, profession is carried on for profit. In any case where a person carries business through an agent (by whatever name called) the place of business of such agent is the place

of business of the enterprise. Availability of premises, facilities, or installations is the only requirement and for that matter it is not necessary that the enterprise must be their owner. Their availability could be secured otherwise also. They may belong to the agent of the enterprise, or to somebody else who places their use at its (enterprise) disposal on hire or on some other consideration. There should be some manifestation of doing business in another jurisdiction, as the concept of permanent establishment means extension of business activity there. That manifestation could be in any form, such a opening an office, participating in the management, supervision or control of such business or any such act which would suggest continuity of commercial dealings, or undertaking functions normally incidental to and in progressive prosecution of the object and purpose of the business organisation or of commercial gain.

There must have to be the business activities within the place of business in a substantial way but not merely the place as indicative of a mailing address. The US Tax Court in *Consolidated Premium Iron Ores Limited v. Commissioner* 28 TC 127 (1957) observed :

"The term 'permanent establishment' normally interpreted suggests something more substantial than a licence, a letterhead, the isolated activities. It implies the existence of an office, staffed and capable of carrying on the day-to-day business of the corporation and its use for such purpose, or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity."

The court emphasized the existence of an office staffed or capable of, or plant or facilities to, carrying on day-to-day or routine business activities. Such existence is a necessary requirement of a business activity which is a basic condition for a PE. A letterhead or mailing address without an office or plant or facility does not mean that the enterprise has a place of business. However, the address is a circumstance indicative of the business activity at that place if there is firm logo, telephone and bank account in the name of the foreign enterprise. In the Consolidated Premium case, a Canadian company with only a mailing address in the United States with no office, no telephone listing, no personnel, or no bank account. It did not form any organisation in the US or set up any sales office or pay any compensation to employees or do any business in the US. It was considered not to have a PE.

11.5-1b PLACE OF BUSIN[BKMEND]ESS - FACILITIES OR INSTALLATIONS - OECD Commentary on Article 5 (paragraph 4) states that the term "place of business" covers premises, facilities or installations used for carrying on the business whether or not they are used exclusively for that purpose. Dictionarily, the word "facilities" means "an opportunity, the equipment, or the resources for doing something; a plant, installation, or establishment" (Illustrated Oxford Dictionary). It, therefore, broadly means resources for doing business. If such resources are available at the disposal of the enterprise, the enterprise could be said to have place of business. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g., for the storage of dutiable goods). The place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise (see the said para 4 of the OECD Commentary). According to Klaus Vogel "The facilities must have features characteristics of a place of 'business'. That is why social facilities such as rest homes for, or living quarters of employees are not permanent establishment."

The facilities may be illegally occupied. The mere presence of an enterprise is not enough. There must be some right to use, which means that the facilities could not be withdrawn or removed without the consent of the enterprise. OECD Commentary illustrates by an example of company having a PE when its employee who, for a long period of time, is allowed to use an office of another company in order to ensure that the latter company complies with its obligations under contracts concluded with the former company (Commentary, Article 5, para 4.3). The German Supreme Court in Football Trainer case (BFH in BStB1 1990 II 23 dealt with a taxpayer who performed his services as a football trainer. He had no legal right to use but performed his services in various football areas. The court held that the taxpayer who is obliged to perform is deemed to have a PE where he performs his services. It means that the entity has PE if it is obliged to perform business activity in the premises of a client. Long-term use of the client's premises would also constitute PE. For example, a painter who, for two years, spending three days a week in the large office building of its main client is deemed to have PE (see OECD Commentary, article 5, paragraph 4.5). Limited use of a place does not constitute a PE. The OECD Commentary illustrates by an example of a road transportation enterprise which : "... would use a delivery dock at customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise

could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise."

The right to use the facilities may relate to the core business and not for the auxiliary business activities of the enterprise.

11.5-1c PLACE OF BUSINESS - CE[BKMEND]RTAIN AMOUNT OF SPACE - A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal (*see* paragraph 4 of the OECD Commentary on Article 5).

Arvid A. Skaar in his book "Permanent Establishment", 1991 Edition, observed as follows in paragraph 10.1, page 126:

"The traditional point of view was that the place of business had to be fixed to the soil. Today, however, it is accepted that the place of business does not have to be actually fixed to the soil, for instance as a building, or a permanent oil installation. It is sufficient that certain place is available for the performance of a business activity, for instance a market place. A German tax treaty commentator has suggested that the location of the place may even be in the open air, while others require that the place of the business remain on the soil or the seabed within the jurisdiction of the treaty.

The PE tradition early accepted in principle a place of business which is moving within a limited area, as in the case with road construction, laying of pipelines, and similar construction works. Nevertheless, it is clearly the conventional wisdom that a PE constituted only if the place of business remains at a 'distinct' place, or at a 'particular site'."

11.5-1d PLACE OF BUSINESS - MACHINERY OR[BKMEND] EQUIPMENT - Premises is a place where goods are sold or services are rendered to customers. It is done through personnel (employees or agents). But sometimes, it is done otherwise them, through automatic equipments (*e.g.*, gaming and vending machine or server), though the personnel may be required for setting up, operating, controlling or maintaining such equipments. Those automatic equipments represent PE (matter is discussed in paras 11.20-7, 11.20-8).

Permanent establishment - "Fixed" Place Permanent establishment - Fixed Place

11.5-2 After a place of business having been found, other requirements of PE are to be seen whether satisfied, whether it is fixed and business is carried through it. The term "fixed place of business" refers to fixed place for the operation of business, including administrative offices, branch, factories, workshop, warehouses, mining fields, or construction sites, etc.

Dictionary meaning of the word "fixed" according to the Shorter Oxford Dictionary is "Definitely and permanently placed or assigned; stationary or unchanging in relative position, definite, permanent, lasting". The more close in the present context is "permanent". "Fixed place" means "permanent place". Permanent establishment, therefore, means "a permanent place of business..." It contemplates a degree of permanency of the activity. It is not used in the sense that it perpetuates but in that it endures. The words "permanent", "business", "carried on" convey an idea of some permanency or regularity something more than casual or occasional. Permanent in this connection should be understood in an objective sense to be the opposite of 'for a limited period'. The expression "fixed" has two aspects: that of space as well as that of time. Klaus Vogel points out that when the article says that the enterprise must carry on its activities in the other state though a "fixed" place, it implies that a certain length of time is required for such business activities. The place of business must have been designed to serve the enterprise with certain degree of permanence rather than merely temporarily. Whether the place of business meets this test of permanence must be judged against the background of all circumstances constituting each individual case. From this point of view the expression "fixed" contains in itself the indication of a time-limit for the existence of the place of business. This is quite independent of the time limit of the specified in clause (I) of paragraph 2 and in paragraph 3. In relation to certain specified types of businesses, the article spells out different minimum periods necessary to consider them as permanent establishment-"six months", "period or periods aggregating to more than six months within any 12 months period", "twelve months" and "183 days" in the US model, the UN model, the OECD model and various treaties. But, even quite independent of these specific paragraphs, the expression "fixed place of business" itself imports that the place of business should exist for some reasonable period sufficient to establish a nexus with the place of operation, though what that period should be would depend upon individual facts of the case—*Advance Ruling P. No. 24 of 1996* [1999] [104 Taxman 377](#) (AAR - N. Delhi). The shortness of period is not relevant as the purpose for which it exists. The duration of the period may be short because of the

nature of the activity or of some account, yet the place of business may be permanent for such period. If the setting of the place of business is done purely for temporary purpose, it may not be taken to be PE unless it is maintained for such a period that it cannot be considered a temporary one.

Duration of the maintenance of a place of business is not always decisive of permanence. It may be short but still PE exists. The business is prematurely liquidated because of, for example, investment failure or death of the taxpayer (OECD Commentary, article 5, para 6.3). Period of time may also be short because of the nature of business, such as where activities are of recurrent nature or where it is exclusively carried in the country. In the latter case connection with the country is stronger; and in the former, each period of time is to be considered in combination with number of times during which the place is used (*see* OECD Commentary, article 5, para 6).

PE exists when business through the fixed place commences and ceases when the fixed place is disposed of or the activity through it ceases that is when all acts and measures connected with the former activities of the PE are terminated (winding up current transactions, maintenance and repairs of facilities). A temporary interruption is not regarded closure (*see* OECD Commentary, article 5, para 11). The setting up of the place of business is not the commencement of business. A business cannot be said to have commenced unless it is ready to discharge the function for which it is set up. The distinction between setting and commencement is that when business is set up and ready to commence then it can be said to have been set up. But before it is ready to commence it is not set up [*see Western India Vegetable Products Ltd. v. CIT* [1954] [26 ITR 151](#) (Bom.) and *CIT v. Ralliwolf Ltd.* [1980] [121 ITR 262](#) (Bom.)]. The setting up is a stage anterior to the commencement and, therefore, the proper meaning of "setting up" would be "ready to commence the business" [*see L.G. Balakrishnan & Bros Ltd. v. CIT* [1985] [151 ITR 270](#) (Mad.)]. As soon as an activity which is essential activity in the course of the carrying on of the business is started, the business must be said to have commenced [*see CIT v. Sponge Iron India Ltd.* [1993] [201 ITR 770](#) (AP)].

Permanent establishment - Temporary suspension of business does not mean loss of permanence

11.5-3 For a place to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. The activity need not be of a productive character. It need not be permanent in the sense that there is no interruption, but operations must be carried out on a regular basis (*see* OECD Commentary on Article 5, paragraph 7).

Temporary suspension of the activity does not rob the place of business of its permanence. It is not necessary that the activity need be permanent in the sense that there is no *interregnum* in its operation, if the operations are carried on with regularity and periodicity. If during the *interregnum* the enterprise has let out its assets, the income arising therefrom is taxable as business profit of the permanent establishment. It is well settled law that if an asset has been acquired and has also been used for the purpose of business it ceases not to be a commercial asset of the business, as soon as it is temporarily put out of use. The income arising as a result of letting it out is taken to be business income. A temporary 'lull' in the activity of the enterprise does not mean its closure. If the place of business is leased out to some other enterprise, and there is no intention of the lessor to return to business the permanent establishment ceases. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases them to other enterprises. It may, however, exist if the enterprise operates and maintains the machines on its account. If a commercial asset of an enterprise is leased to a place of business, the activity will render that place a permanent establishment. If leasing is done without maintenance of a place of business for such leasing, the leased property would not constitute a permanent establishment of the lessor. If the place of business is leased out temporarily to another enterprise, the income arising as a result thereof would not cease to be business profit of the permanent establishment. In India various High Courts and Supreme Court have held that where an assessee has not intended to go out of the business but during the period of interruption leases out the business or its assets the income is assessable as business income. In *CEPT v. Shri Lakshmi Silk Mills Ltd.* [1951] [20 ITR 451](#) (SC), it was held that the leasing of a dyeing plant for a short period was business income. In *Sri Ram Mahadeo Prasad v. CIT* [1961] [42 ITR 211](#) (All.), the Court held that the newly set up oil mills which were temporarily let out were commercial assets. In *CIT v. Vikram Cotton Mills Ltd.* [1977] [106 ITR 829](#) (All.), it was held that the company had no intention to discontinue its business, and that the income derived from lease of plant and machinery was business income. In *Addl. CIT v. Rajindra Flour & Allied Industries (P.) Ltd.* [1981] [128 ITR 402](#) (Delhi). It was held that the leasing of the mill was essentially a temporary measure to tide over a period of difficulties and the letting must be taken as one possible way available to the assessee for exploiting its commercial

assets and had to be treated as part and parcel of its carrying on of the business. In *CIT v. Northern India Theatres (P.) Ltd.* [1981] [128 ITR 497](#) (Delhi). It was held that lease of cinema house coupled with interest-free loan was an arrangement made by the assessee for both financing the setting up of the cinema and the exploitation of the same in a commercial manner. Thus, if the intention of an assessee is to go out of business altogether, (which intention could be gathered from its conduct, whether it maintains office or establishment for carrying on the business, and from other surrounding circumstances) and to enjoy the income arising from the lease of the property in its capacity as its owner, the income is not assessable as business income but as the one arising from the property. Temporary suspension of the business activity does not change the character of income derived from the leasing of the commercial asset during the period of suspension to anything different from business, as such, a suspension does not mean closure of business.

The position could be summed up as stated in paragraph 11 of the OECD Commentary on Article 5; A temporary interruption of operations cannot be regarded closure of permanent establishment. It ceases to exist with the disposal of the fixed place of business or with the cessation of an activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). If a fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's. In general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Permanent establishment - "Through" - Business connecting test

11.5-4 The expression "fixed place of business" through which business of an enterprise is partly or wholly carried on is wide enough to take in any place at, in or from which any or all of the business activities of the enterprise are carried on. The word "through" means that the activities should be performed in, from or at the place of business. There should be connection between the place of business and business activities. If such a connection is absent, there is no PE [see *MNR v. Tara Exploration & Development Co. Ltd.* 72 DTC 6288 [1972]. Also see *DIT v. Morgan Stanley* [2007] [292 ITR 416](#) (SC)].

The words "through which" applies to any situation where business activities are carried on a particular location that is at the disposal of the enterprise for that purpose; for instance, an enterprise engaged in paving a road is considered to be carrying on business "through" the location where this activity takes place (see paragraph 4.6 of the OECD Commentary on Article 5). Certain location must be available through which business activities could be performed. It may, besides a premises, equipment or agent, a market place, road construction, laying of pipelines, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand, customs depot etc. Business activity may be done through premises, equipment or a person.

Business is generally stated to be carried on at or in or from a place. The word "through" cannot have different meaning. "The word is used to be consistent with the language of article 7 which talks of the foreign enterprise making profits through a permanent establishment in the relevant territory." - *Advance Ruling P. No. 24 of 1996* [1999] [104 Taxman 377](#) (AAR - N. Delhi). "Through" means the medium for carrying on business. It may be premises, equipment or a person.

It means an intimate connection between the business activities and the place of business. That such activities are performed in, from and through the place of business. If an enterprise maintains a fixed place and also carries on business, but there is no connection between the two, there is no PE. That connection may be established through human beings or automatic machineries.

Business connection means a relation between the business carried on by a person which yields profits or gains and the place of business. That relation must be real and intimate as illustrated by the decision of the Canadian Supreme Court in *MNR v. Tara Exploration and Development Co. Ltd.* 72 DTC 6288 [1972] wherein the Court held that the profit making activity of an Irish company could not be attributed to its office in US whose purpose was merely to comply with the requirements under certain Canadian Tax Laws. There was no PE because the company did not perform any business activity through the office.

Paragraph 2 of article 5 gives illustrative list of permanent establishment. They meet the requirement of the "place". That paragraph refers to places included as PE [*DIT v. Morgan Stanley* [2007] [292 ITR 416](#) (SC)]. But the other requirement that the business should be carried through them must be satisfied. An "office", a "factory", a

"workshop", or a "mine" are the places of business and not the PE. They would be PE if the business is carried through them. The list is not exhaustive, as the expression "includes" suggests. The two of the terms, "a place of management" and "a branch" are the real examples of the PE.

Permanent establishment - Enterprise - Meaning of Permanent establishment - Enterprise - Meaning of

11.6 Enterprise is an economic activity carried on by an entrepreneur who is a person conducting professionally an organised economic activity for the production or exchange of goods or services. It is organisation of capital and labour with a view to making a profit by participating in the market activities. It has the following features:—

- ...■•The activity must be exercised in an independent manner;
- ...■•It must consist of repetition of well defined actions;
- ...■•It must have an economic character.

Indian treaty with Greece defines enterprise to mean as an industrial or commercial enterprise or undertaking carried on by the resident.

The term "enterprise" includes any form of undertaking, whether carried on by an individual, partnership, corporation or any other entity. It has no exact counterpart in the taxing code of the United Kingdom—*Ostime v. Australian Mutual Provident Society* [1959] 38 TC 492, 517 (HL) per Lord Radcliffe and also *Theil v. Commissioner of Taxation* [1990] 90 ATC 4717. In *Theil*, the Court held that the term "enterprise" connotes both the activity itself and the means by which the activity is engaged. In Canada, French version of the Income-tax Act uses the expression "enterprise" whereas the English version uses the business.

The French version of a Canadian treaty can be interpreted under article 3(2) of the OECD Model by reference to the internal law in accordance with the French version of the Income-tax Act. This permits the English version of the treaty, using enterprise, to be interpreted on the basis that enterprise and business have identical meanings.

The PE definition and the business profit article refer to "enterprise" and not "resident of a contracting state" as other articles dealing with investment or personal income, refer Article 7 refers to "profits of an enterprise". The expression "enterprise" has been defined in the OECD Model in Article 3 as carrying on any business. The expression "profits of an enterprise" means profits from carrying on business. Article 7 does not refer to a "person" or "resident of a contracting state". It would mean that for taxability of business profits, it is not necessary that a person has to be resident of either of a contracting state or he actually carries on the business activity. In *Padmore v. IRC* [1987] BT C 3, the UK Court of Appeal held that even though a partnership was not a taxable unit under Jersey law as also under the English law, the treaty provisions applied to partnership. If a business activity is carried on in a country resulting in profits, it is to be taxed in terms of article 7 in that country irrespective of the person having not in fact carried on the activity either through his employees or agent. That person may be deemed to have PE. For example, business activity undertaken by a partnership firm, joint venture, or a trust, the partners, members or the beneficiaries may be deemed to have a PE notwithstanding that they are not physically present through either the employees or agents. The matter is discussed in detail, later.

Permanent establishment - "Business of an enterprise...carried on" - Meaning Permanent establishment - Business of an enterprise...carried on - Meaning

11.6-1 Since the expression "enterprise" means a business activity, the expression "business of an enterprise...carried" if interpreted literally would lead to absurd reading as "business of a business...carried on". The French version of the OECD Model, however, does not lead to such a reading. It uses the expression which if translated in English would mean "...the enterprise carries on..." The expression "enterprise", therefore, is used in the sense of the person carrying on business. Thus, enterprise covers both an activity itself, and means by which an activity is engaged in, such as an individual or any other legal entity and any union or group of individuals associated in fact although not a legal entity. Paragraph 1(c) of article 3 of the Model defines the expression "enterprise of a Contracting State" as meaning an enterprise carried on by a resident of a Contracting State. Thus, PE is a fixed place of business through which the activities of the business are carried on. A person may carry on more than one enterprise. Thus, the business of an enterprise is the business activity of a person, out of his many activities.

Carrying on of the business of the enterprise through fixed place means usually that persons who, in one way or the other, are dependent on the enterprise (personnel) conduct of the business of the enterprise in the State in which the

fixed place situated.

Permanent Establishment - Confined to commercial and industrial activitiesPermanent Establishment - Confined to commercial and industrial activities

11.6-2 The concept of permanent establishment is reserved for the commercial and industrial activities. It does not include independent personal services. There is a separate article (article 14) which deals with such services when they are carried on through fixed base in another State. That article does not make reference to an enterprise. (That article has now been deleted from the OECD Model Convention). The activity may be pursued through human beings (employees or agents). It may also be pursued without them, through vending machines or automated devices. If there is no activity, there is no PE, as for example mere transportation of oil through a pipeline.

Carrying on businessCarrying on business

11.6-3 Carrying on of the business is the basic requirement for the existence of PE. The medium for doing so may be a place, equipment or an agent. For carrying an business human input is necessary, either by the employees or dependent agents. The words "carrying on business" require something more than merely selling or buying. Whether a person carries on business must depend upon the volume, frequency, continuity and regularity of transactions of purchase and sale in a class of goods and transactions must ordinarily be entered into with profit motive [*Board of Revenue v. A. M. Ansari* (1976) 38 STC 577 (SC)]. The business is carried on where the management and control lie.

In the Websters' Third New International Dictionary, the phrase "carry on" is defined as "conduct and manage". The phrase would mean that the person carries on the business only at its principle office where the business decisions are made and the control and the management are exercised over the business [*CIT v. Associated Finance Co. Ltd.* [1992] [195 ITR 742](#) (Cal.)].

The expression "carries on business" has a very wide import and in generic sense "business" is any purposeful activity, any activity directed towards some end, an activity engaged in as normal, logical or inevitable and usually extending over a period of time. The phrase "carries on" suggests an occupational undertaking to which one habitually devotes time, attention or effort with substantial regularity [*see Fahs v. Crawford* F 2d 315 (US)]. The expression "business" has a very wide import and would encompass almost anything which is an occupation, as distinct from pleasure-anything which is an occupation or duty which requires attention is business (*Bakhtawar Singh Balkrishan v. Union of India* AIR 1983 Delhi 201). The Supreme Court in *Barendra Prasad Ray v. ITO* [1981] [129 ITR 295](#) has held that the expression "business" does not merely mean any trade or manufacture and it is being used as including within its scope professions, vocations, and callings for a fairly long time. And the word "business" is one of wide import and it means an activity carried on continuously and systematically by a person by the application of his labour and skill with a view to earning income. The motive of carrying of activity with a view to earning income is relevant for income-tax purposes. "Business" has been defined in *Black's Law Dictionary* as "activity or enterprise for gain, benefit, advantage or livelihood" [*see Goa Urban Co-operative Bank Ltd. v. Noor Mohd. Massa* [2004] 20 ILD 2 (SC)]. The US Supreme Court in *Groetzinger v. Commissioner* 107 S Ct. 980 (1987) held that in order to be engaged in business or trade, the taxpayer must be involved in the activity with continuity and regularity with the primary purpose of making a profit. Thus continuity and regularity of the taxpayer's activity are critical.

A business is said to be carried on in India, if the activities are carried through a fixed place or a place which may be a place of management, branch, office, factory, workshop etc., or through a building site, or a project or through an agent.

Section 2(13) of the Indian Income-tax Act defines the expression "business" inclusively as including any trade, commerce, or manufacture or any adventure in the nature of trade, commerce, or manufacture. Any activity with a profit motive relating to trade or commerce or manufacture is a business. If that motive and nexus are absent, business cannot be said to have been carried on. For example, if a non-business activity results in some scrap or unwanted material which should be cleared so that accommodation could be saved, and if sales were made with an intention to reduce the congestion, the person cannot be said carrying on the business in the scrap or unwanted material [*see State of Tamil Nadu v. Board of Trustees of the Port of Madras* [1999] 114 STC 520/2 JT 410].

There is a distinction between a business and the management of investments or real estate. Separate provisions exist for business income and investment income (immovable property royalties, dividend and interests) or income

from property or capital gains. If the management requires regular and continuous activity of the kind which is commonly concerned with the employment of labour, the purchase of material, the making of contracts, and many other things which come within the definition of business, the income is to be characterized as business income [see *Pinchot v. Comm'r* 113 F.2d 718 (2nd, Cir)]. In *Pinchot* the agent of a UK resident managed property in US, leasing them, collecting rents, paying expenses, taxes and mortgage interest and other obligation, with a power to buy and sell properties. If the activities go beyond ownership or receipt of income from real property and are considerable, continuous and regular, the enterprise can be said doing business [see *Lewenhaupt v. Comm'r* 20 TC 151 [1953] aff'd 221 F.2d 227 (9th Cir. 1955)] and if sporadic, irregular and minimal it cannot be so but said to be deriving from real property. Whether income from business activity or real property, depends upon its extent. If extensive, including sales, purchases, and leasing of real estate ; considerable, regular, continuous, it is business income.

Similarly, management of investments may include purchases and sales, collection of income, record keeping, and yields income in the form of dividend, interest or capital gains, investment activities in the source State must reach to a certain level to be taxed as business income [see *MNR v. Tara Exploration & Development Company Ltd.* 72 DTC 6288 [1972]. The US Tax Court said in *Adda v. Comm'r* 10 TC 273 [1948] aff'd 171 F.2d 457 (4th Cir 1948)] that "Trading in commodities for one's own account for profit may be 'trade or business' if sufficiently extensive". Income from investments is treated as business income if it is effectively connected with business enterprise.

Similarly management of patents and copyright is to be taken business activity, if it involves sufficiently extensive activities (See also the following para).

Carrying on business - Leasing of tangible or intangible property

11.6-4 Letting or leasing out tangible (equipment, facilities or installations) or intangible property (patents etc.) through a fixed place of business is an activity which could be taken as carrying on of business through that place. Paragraph 8 of the OECD Commentary on Article 5 provides :

"Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example, participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the same time limit of twelve months applies. Other cases have to be determined according to the circumstances."

An asset leased out through a fixed place of business shall not constitute a PE, if it is done with responsibility entirely left to the lessee (as for example, in the case of financial lease, in which case the lessor does not have right to use the place) even if to operate or maintain it the lessor supplies personnel, but shall constitute if the responsibilities of the personnel go beyond (as for example, in the operation lease) such as participation in the decision making or operating or maintaining under the responsibility and control of the lessor. Thus, if the responsibility of the employees of the lessor is limited to no more than to operate or maintain or for that purpose to train the lessee's employees, there is no PE. Similarly, mere installation of gaming or vending machines is not enough, if it is operated not by the enterprise but by the lessee who is responsible for maintenance and service and collection of money.

Carrying on business - Partnership

11.6-5 As discussed in para 9.13-1, a partnership is an association of two or more persons as co-owners of business who have agreed to share the profits of business carried on by all or any of them acting for all; such persons are individually called partners and collectively a firm. Partners carry on business both as principles and as agents for each other and participate in the profits. Such participation will create a PE in the country where the partnership carries on business through a fixed place. Business in a country carried on by a partnership firm is the business carried by a partner and a PE of the firm is the PE of the partner. A foreign partner may be considered to have a PE through the place of business of a partnership. "The office premises of the partners collectively, were also the office premises of any one partner" (*see, No. 630 v. M.N.R DTC 300 [1959] (Subway case)*). In *Donroy Ltd. v. United States* 301 F.2d 200 (9th Cir. 1962), the Court held "...each partner, whether general or limited has an interest as such in the assets and the profits of the partnership, including the physical plant or offices at which the partnership conducts its business, so that the office or the permanent establishment of the partnership is, in law, the office of each of the partners - whether general or limited". In *Johnston v. Comm'r* 24 TC 920 [1955], Johnston a citizen and resident of Canada was deemed to have a fixed place of business in the US through the place of business of his partner there. In *Robert Unger v. Comm'r* 58 T. C. M 1157 (1990), a Canadian Dentist who was a limited partner in a US limited partnership had a PE in the US.

Thus, a place of business of the partnership or any other partner in a country is the place of business of the foreign partner who is deemed to have PE, irrespective of whether he does not participate in the actual conduct of the business or have no influence upon the business activities.

The partnership principle is applied in respect of any other type of arrangements where there is a direct participation in the earnings of a business activity.

Carrying on business - Joint venture

11.6-6 Joint venture is a commercial undertaking by two or more persons, differing from a partnership in that it relates to the disposition of a single lot of goods or the completion of a single project. Its duration is limited to the period in which the goods are sold or the project is carried out (Eric L. Kohler : *A Dictionary for Accountants*). It is an arrangement between two or more enterprises to undertake a specific venture and to share profits arising therefrom, one may be contributing technical and the other financial or management skills, required for the project. Joint place of business is a place of business for each member or a joint venture partner could have a place of business through the place of business of another partner.

For example, a school is run in collaboration of foreign resident who does not take active part in teaching or otherwise in its administration but paid in proportion of the school's monthly income as consideration for allowing its syllabus to be followed, education imparted according to its norms and standard and promising to issue certificates to the successful candidates on completion of the course. This is a joint venture. The activity is a business activity of the foreign resident and the school is a fixed place of business.

Carrying on business - Trust

11.6-7 A trust as stated in para 9.14-3 is a legal obligation established by an individual (the "settlor") binding one or more persons (the "trustees" to hold and deal with the assets (the "trust property") for the benefit of the other persons (the "beneficiaries"). Income of the trust is taxed in the hands of beneficiaries if they are known and certain. A foreign resident who is a beneficiary of the trust may be deemed to have a PE where the enterprises in which the trust has invested carry on business. Portfolio investment in the business activities of corporate entity is, however, classified as dividend and not as business income.

Carrying on business - Franchising

11.6-8 Franchising is an authorization granted by a company to sell its goods or services in a particular way. Consideration received is to be characterized as fee if it is not dependent on profits. The agreement if provides the franchiser to receive a share in the gross or net profits, is like a joint venture or partnership agreement and the amount is to be characterized as business income. The business place of the franchisee is the PE of the franchisor.

Carrying on business means business carried by employees or dependent agents

11.6-9 For carrying on business human input is necessary, either by employees or dependent agents. Carrying on of the business of an enterprise means that its personnel conduct the business in the State in which the fixed place is situated (*see OECD Commentary, article 5, para 2*). The term "personnel" includes its employees and other persons receiving instructions from the enterprise (e.g., dependent agents). Business may be carried through the fixed

place. It may also be done through automatic equipment and the activities of the personnel being restricted to setting up, operating, controlling and maintaining of such equipment. There is no PE if the enterprise only sets up and does not operate and maintain the equipment for its own account but leases out to another enterprise (*see* OECD Commentary, article 5, para 10). In that para, it is also mentioned that it makes no difference whether or not the dependent agent is authorized to conclude contracts if he works at the fixed place of business.

Permanent establishment - Business carried on wholly or partly

11.7 Besides existence of the place of business, and its fixity, the other essential ingredient of the permanent establishment is that the business is carried on through such place of business wholly or partly. There should be nexus between the place of business and the activity of the carrying on of business. The word 'wholly' has been used with reference to the quantum of activity. All the activities necessary for carrying on a particular business should be undertaken through the place of business or they originate therefrom or have relation or connection thereto. The nexus between all the components of a business activity and the place of business should be complete. The word 'wholly' has no reference to the extent or nature of the business, but to the extent of the carrying on of the activity relating thereto. The activity must be with reference to and only for the purpose of carrying on of the business of the enterprise. The natural and plain meaning of the word 'wholly' is entirely, completely, fully, totally and in every respect— *Smt. Usha Majumdar v. Smt. Smrity Basu* AIR 1988 Cal. 115. Wholly means all activities which constitute business carried on exclusively in the country (*see* OECD Commentary, para 6).

The expression 'wholly or partly' suggests that the activity relating to carrying on of business may have many components and all these taken together constitute one whole ; all or any of them may be undertaken. To carry on business, there must exist the characteristics of volume, frequency, continuity and system, indicating an intention to continue the activity of carrying on the transaction—*State of Gujarat v. Raipur Mfg. Co. Ltd.* [1967] 19 STC 1 (SC) and *CIT v. Motilal Hirabhai Spg. & Wvg. Co. Ltd.* [1978] [113 ITR 173](#) (Guj.). To regard an activity to be business, there must be course of dealings, there must be some real and systematic or organised course of activity or conduct. The continuous repetition of transactions constitute business. Business involves a constant flow of transactions upon transactions everyday, subject to risks, vicissitude requiring acts of management by those who wish to profit by it. Thus, when all transactions, their frequency, volume are managed or controlled or carried out through the fixed place of business, the business could be said to have been carried on wholly through it. Even if the entire activities relating to the carrying of business are not undertake therefrom but only a part is done, the necessary requisite condition for the establishment of permanent establishment is satisfied.

In the OECD Commentary on article 5, para 3, it is stated "...Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organization a particular establishment has a 'productive character'. It is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory." The words "each part contributes to the whole" indicate that the business may not necessarily be carried wholly through the place of business; even done partly may be sufficient.

Permanent establishment - Specified business presence

11.8/14 Paragraph 2 defines permanent establishment inclusively. It sets out many types of business presence which do not meet the strict standard as laid down in paragraph 1. From the list as given in paragraph 2, one gets, an impression of the kind of premises the term "place of business" covers. That paragraph refers to places included as PE [*see DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) (SC)]. Inclusive definition is resorted [*see Reserve Bank of India v. Peerless General Finance & Investment Co. Ltd.* [1987] 61 Comp. Cas. 663 (SC)].

- ..■to enlarge the meaning of the words as to take in the ordinary, popular and natural sense of the words and also the sense which the statute wishes to attribute to them,
- ..■to include meaning about which there might be some dispute, or
- ..■to bring under one nomenclature all transactions possessing certain similar features but going under different names. Depending upon the context, in the process of enlarging, the definition becomes exhaustive.

The term "including" according to the context, expresses an enlargement and has the meaning of and, or "in addition to", "including" within statute is interpreted as a word of enlargement or of illustrative application as well

as a word of limitation or merely specifies a particular thing already included within the general words therefor used.

Paragraph 1 introduces the definition with the expression "means" defining it rather strictly, while paragraph 2, with "includes", setting out many types of business presence which fall short of the strict standard. As aforesaid, the word "includes" is often used to enlarge the meaning of the words as comprehending not only such things as they signify according to their natural import but also things which the definition declares to include. The intention is to give a wide meaning to the word. Such word then denotes extension and cannot be treated as restrictive in any sense. The restriction is, however provided when the definition goes on illustrating which are not be taken permanent establishment. Or by laying down negatively what shall not constitute permanent establishment such as use of facilities solely for storage, display or delivery of goods or maintenance of stock or goods for purposes of processing by another enterprise, or a fixed place of business for the purpose of advertising for supply of information, for scientific research or for activities which have preparatory or auxiliary character.

The OECD commentary says that examples in paragraph 2 are to be seen against the background of general definition given in paragraph 1 and it is assumed that the contracting states interpret the terms listed, "a place of management", "a branch", "a office" etc., in such a way that such places of business constitute permanent establishment only if they meet the requirements of paragraph 1. "This argument" observes the Authority for Advance Ruling in - *Advance Ruling P. No. 28 of 1999* [1999] [105 Taxman 218](#) (AAR-N. Delhi), "runs contrary to the well-established principle of statutory interpretation that an inclusive definition is intended to add to the primary meaning so as to bring within its scope items which may or may not fall within the scope of the primary definition. That apart, even assuming, at best, that the inclusive clause should be interpreted 'against the background' of the general definition contained in paragraph 1 and bear some analogy to it, all that can be said that sporadic or isolated activities of the kind rendered in clause (1), will not be sufficient to constitute a PE and that there should be some degree of 'continuity' or 'durability' and a framework against which the services are rendered. That kind of framework and degree of stability and continuity is present in the present case."

The words in paragraph 2 of article 5 are such as could be covered within the general definition in paragraph 1. The paragraph gives a list of specific example of places which are *prima facie* PE. An "office" a "factory", a "workshop", or a "mine" are the places of business and not the PE. They would be PE if business is carried through them. The two terms "a branch" or "a place of management" are, however, PE. Thus, the general definition is supplemented by a list of illustrative examples, including a place of management, a branch, an office, a factory, a workshop, a mine, quarry or other place of extraction of natural resources, and, a building site or assembly project. The qualifying restriction as set out in paragraph 1 is not applicable as regards "permanency". With respect to them, permanency is presumed. They need not be permanent in actuality, in the sense as paragraph 1 insists. The period for which they should exist is not relevant. There is no reference to any minimum period for which the permanent establishment should be in existence within a state in any of such listed business presence. Shortness of the period is not relevant for which they exist.

Thus, the emphasis on the place of business appears to be on the measure of control over the physical facilities of establishment, however, insignificant it might be, as exercised by the establishment. The definition as given in the OECD model has been extended in the UN model so as to include a building or construction, or assembly project, whose duration extends six months (or irrespective of length of time if the project charges exceed 10 per cent of the sale price of the machinery or equipment), and management consultancy services, if the representatives of the enterprise rendering such services stay in the country of source for more than six month in a period of 12-months.

The focus is on the place of business so that the said control could be exercised. Place of business usually means management office, a branch, a representative office, a factory, a place where natural resources are exploited, or contracted projects of building, installation, assembly or exploration are conducted. Even sales outlet is taken a PE (*see* Indian agreement with Malaysia, Armenia, Slovenia, Sudan, Uganda). It is on place or building which has an effective role to play in doing business, whether as place where manufacturing is done, or for storing the manufactured articles, or for the administration or management of the business.

As aforesaid, a person carries on business only at a place where business decisions are made and the management and control are exercised over the business. It may therefore be a place of management, a branch, an office, a factory or workshop, a place of extraction of natural resources, etc.

Permanent establishment - Place of managementPermanent establishment - Place of management

11.15 A place of management is a category of PE separate from an office. Office is place of business for clerical and administrative work; place of management is a place from where control and supervision is exercised. A fixed place of business which has the function of controlling or managing an enterprise is the place of management and the PE of that enterprise. Place of management is the management's actual location. There must have to be place from where the "management" is exercised. It must be fixed. Mere performance of managerial functions temporarily is not sufficient, if the place is not fixed from where significant decisions are made.

The place where place of management exists is the place where control and management of an enterprise reside. 'Control and management' have been figuratively described as the 'head and brain'. In the case of individual, this test is not necessary because his residence in a country for a certain period is enough, as he would necessarily bring his 'head and brain' with him. The 'head and brain' of the company is the board of directors and if the board of directors exercises complete local control, then the company is also deemed to be resident. In the case of a firm, an association of persons and a Hindu undivided family, the control and management can be exercised by one or more of the group. The expression 'control and management' means *de facto* control and management and not merely the right or power to control and manage - *Bhimji R. Naik v. CIT* [1946] [14 ITR 334](#) (Bom.) and *CIT v. Nandlal Gandadal* [1960] 40 ITR 1 (SC).

Permanent establishment - BranchPermanent establishment - Branch

11.16 A corporation may be engaged in a trade or business in a foreign country through a 'branch office'. Such an 'office' is referred to 'permanent establishment'. Under section 2(a) of the Indian Companies Act, a branch office in relation to a company means—

- a. any establishment described as a branch by the company; or
- b. any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company; or
- c. any establishment engaged in any production, processing or manufacture.

A branch means an extension or sub-division of an enterprise. In the Lexicon it is defined thus: "A division; sub-division; a department, a component portion of an organisation or system". It is a projection of an entity depicting management and control of the entity over them. A branch connotes a physical presence. It is an office with an independent administration. Where a non-resident has an office and employs staff to carry on his business, he is said to have a PE. The question arises as to what degree of physical presence is necessary to constitute a branch. Plant and machinery used in connection with construction project can constitute a branch. A vending machine is a branch, with minimal personnel to maintain. An "agency" is, however, not a branch, as it does not require physical presence. It is treated as PE of different kind. Agency requires a relationship with a company or an individual on whom non-resident has conferred authority of making contract on his behalf.

The branch office is not regarded as a separate legal entity. Its profits are the profits of a corporation owning the branch office. It is different from a subsidiary which has a legal identity of its own - *CIT v. Stewarts & Lloyds of India Ltd.* [1987] [165 ITR 416](#) (Cal.). The subsidiary may be a branch office of a foreign establishment under certain circumstances. If it is engaged in transaction with or on behalf of the foreign enterprise as an agent of the parent company in circumstances pointing out to a trading in host country, it can be said to be performing functions on behalf of that enterprise in the same way as any other could so do and be considered a permanent establishment - *Fire Stone Tyre & Rubber Co. Ltd. v. Lewellin (H.M. Inspector of Taxes)* 37 TC 111. To that extent the subsidiary is the branch office of the foreign enterprise, in spite of its having independent and own legal status, and the profits attributable to that activity are the profits of the aforesaid foreign enterprise. A mere use by a parent of its subsidiary company's space and employees would not constitute permanent establishment - *Tara Exploration & Development Co. Ltd.* 24 DTC 6370 because a permanent establishment requires persons with authority to carry on some part of taxpayer's money making activities. The very fact that a company which is a resident of a State is controlled by a company which is resident of a foreign State does not of itself constitute a permanent establishment of the foreign company. A clause to that effect is usually found in all tax agreements, as a part of the clause dealing with the concept of 'permanent establishment'.

Thus, the tax agreements do not affect the tax treatment of subsidiary company, unless it could be performing such functions on behalf of the parent company as to clothe it with 'permanent establishment' of the parent. As for the branch office, it is to be taken as a projection of the parent enterprise.

The Authority for Advance Ruling in *Dun and Bradstreet Espana S.A., In re* [2005] [272 ITR 99](#) (AAR - New Delhi) observed that one associate company of a group of companies *per se* cannot be branded as a branch or sales outlet of another and "To hold one associate company as the branch or sales outlet of another, there must be some material indicative of the characteristic of 'branch' or 'sales outlet'."

Permanent establishment - Sales outletPermanent establishment - Sales outlet

11.16-1 A sales outlet has the same attribute as of a branch. A branch or a sales outlet are projections of an entity depicting management and control of the entity over them [see *Dun and Bradstreet Espana S.A., In re* [2005] [272 ITR 99](#) (AAR - New Delhi)].

Permanent establishment - 'Office'Permanent establishment - 'Office'

11.17 The word "office" is defined in the Chambers 20th Century Dictionary as "a place where business is carried on; a body or staff occupying such a place ; a building in which it is housed." In the Shorter Oxford Dictionary on Historical Principles, Third Edition, the meaning of the word 'office' is given as a place for the transaction of business; often including the staff, or denominating their department ; applied to the room or department in which the clerical work of an establishment is done; also to that in which the business of any department of a large concern is conducted, as the booking office, enquiry office, etc. at a railway station, sometimes transferred from the place of business to the company, *i.e.*, the part of the house specially devoted to household work or service; the kitchen and its appurtenances; including out-houses [see *CWT v. Cosmopolitan Hospitals (P) Ltd.* [2003] 185 CTR (Ker.) 111]. The word 'office' has various meanings depending upon its context - *Kanta Kathuria v. Manak Chand* AIR 1970 SC 694. It may mean a place or a premises for administration or clerical work or for transacting business. It may also mean a situation, post or appointment. An office means a position which requires a person holding it to perform certain duties and discharge certain obligations - *Maharaj Shri Govindlalji Ranchhodlalji v. CIT* [1958] [34 ITR 92](#) (Bom.), a position to which certain duties are attached - *Zamorin Raja of Kozhikode v. CED* [1957] 32 ITR (Suppl.) 1 (Mad.). Thus the word 'office' is commonly understood as suggesting a position of trust or authority or situation emphasising the idea of employment in a subordinate position - *Padam Sen v. State of UP* [1961] 1 SCR 884. But the term "Office" when it is used as a place of business or to conduct office work has been defined in Black's Law Dictionary as "a place for the regular transaction of business or performance of a particular service". In Webster's Encyclo-paedic Unabridged Dictionary of English Language, 1996 edn. "Office" is defined as 'a room, or set of rooms, or building where the business of commercial or industrial organisation or of a professional person is conducted; the main office of an insurance company; a doctor's office. The Oxford Dictionary defines the term "office" "to be a room or building used as a place of business, especially for clerical or administrative work" see *Goa Urban Co-operative Bank Ltd. v. Noor Mohd. Moosa* [2004] 20 ILD 2 (SC). If a foreign enterprise maintains a place or a premises for transacting business or entrusts to a person to do certain duties and discharge certain obligations, it can be said to have a permanent establishment. The concept determines the location of the director's office, the place where the company is resident or where the paying company is located.

In *Tekniskil (Sendirian) Berhard v. CIT* [1996] [222 ITR 551](#) (AAR), a Malaysian company claimed that fees received by it for supply of skilled labour to a Korean company for carrying out contracts awarded by the ONGC in the territory of Bombay High, arose out of the business supply of the skilled labour and cannot be taxed in India because of the absence of PE. The AAR held that the income derived could be described as "fees for technical services", but since such fees were earned in the course of business of supply of skilled labour, it constituted business income. It, however, held that the activity of recruiting foreign labourers abroad and supplying them to another foreign company in India would not constitute PE. It could have been so if the Malaysian company had maintained in India—

- recruitment office for labour;
- an establishment to impart training to or to conduct tests and examination for the labourers or to issue qualification certificates;
- an organisation making arrangement for reception, boarding and lodging of the labourers, before they were taken over by the other company; or
- establishment to look after the salary payment, insurance, health and material treatment of the labourers.

Permanent establishment - Representative officePermanent establishment - Representative office

11.17-1 Representative office may mean place of business but it is not taken to be permanent establishment, if its activities are confined to matters of preparatory, auxiliary nature, or are of the nature of support functions, viz., collection of information and transmitting the head office, distribution or dissemination of information concerning the product of foreign enterprise, or receiving enquiries on behalf of the foreign enterprise. If the representative office does not receive any income or does not sign any contract, or is not looked upon in the host country as a projection of the foreign enterprise, that is, if its activities are confined to supporting its head office and do not extend to areas which contribute to the generation of income or are necessary steps with commercial contents for the carrying on business it (the representative office) cannot be taken as permanent establishment. Doing research, providing information, or keeping liaison are not the activities which have necessarily to be taken for the carrying on business as they lack the characteristics of commerce or trade. But if any of such activities extends to the domain of rendering consulting and other services or liaison to parties other than the head offices which engage them, the representative office would be taxed on the income attributable to such activity.

For example, a purchase office would not be a PE because the act of purchasing in itself yields no profit. Unlike, producing, converting, processing, manufacturing, sorting, preserving, assembling, packing and transporting, a purchase adds no value to the thing bought. Thus, mere purchase of goods by an establishment in one country for the supply or selling or processing establishments in the other country is not regarded as a base for tax liability in the country where purchase is made, only if its activities are confined to purchasing only and not rendering other services such as sorting, grading, or packing goods to the enterprise to which it belonged.

The Swiss Bundesgericht (judgment of the Swiss Bundesgericht dated 17-9-1977 on Swiss-Spanish Treaty) had to interpret the Swiss-Spain treaty and to decide whether the 'representative office' of a Spanish bank constituted a 'permanent establishment' in Switzerland. The Bundesgericht, whilst it cited the commentary of the 1963 OECD Model, held that it was not such a 'permanent establishment' of the Spanish bank in Switzerland. Similarly, the US Revenue Ruling (No. 72-1-418 on US-German Treaty) has decided while dealing with US-German tax treaty that a German bank representative office in US did not constitute a 'permanent establishment' of the German bank in the US - see *CIT v. Vishakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP).

Permanent establishment - Administrative officePermanent establishment - Administrative office

11.17-2 Similarly as discussed in the preceding paragraph, an administrative office, especially in the banking and the financial fields, or regional headquarters, is not permanent establishment provided no clear evidence of trading emerges. All such offices - be they are representative offices or regional headquarters, administrative offices - derive their validation from the narrow definition of "permanent establishment" in some double taxation agreements, and also from this explicit exception set out in such definitions as such offices or headquarters fall short of the activities of a trading office.

Permanent establishment - 'A factory'Permanent establishment - 'A factory'

11.17-3 A factory is a building or a collection of buildings, usually with its equipments or plant, appropriated to the manufacture of goods; the place where workmen are employed in fabricating goods, wares or utensils - *Webster's New International Dictionary*. It means a premises in which manufacturing process is carried on, as also the precincts thereof - *Uma Sankar Srivastava v. State of UP* 1964 SCN 199. Various statutes in India have defined this expression, and all generally hold that it means any premises, including the precincts thereof, in any part of which a manufacturing process is being carried on or is ordinarily so carried on, whether with or without the aid of power - *Employees' Provident Funds Act, 1952; Central Excises and Salt Act, 1944; Employees' State Insurance Act, 1948; Payment of Wages Act, 1936; Factories Act, 1948; Industries (Development and Regulation) Act, 1951*. A factory is, therefore, a building in which goods are manufactured. It may also mean a place where a number of traders reside in a foreign country for the convenience of trade - *Wharton's Law Lexicon*.

Permanent establishment - WorkshopPermanent establishment - Workshop

11.18 Workshop is any premises wherein an industrial process is carried on. It is an establishment where manufacture of goods or other materials is carried on. It is understood in the trade as having a very wide connotation.

Permanent establishment - WarehousePermanent establishment - Warehouse

11.19 'Warehouse', according to the *Oxford Dictionary*, is described as "a building or part of a building used for the storage of merchandise; the building in which a wholesale dealer keeps his stock of goods for sale; a building in which furniture or other property is housed, a charge being made for the accommodation : a Government

building (more fully bonded warehouse) in which dutiable imported goods are kept in bond until it is convenient to the importer to pay the duty". According to *Webster's New Twentieth Century Dictionary*, 'godown' means a warehouse and 'warehouse' means 'a building where wares or goods are stored, before being distributed to retailers : a storehouse'. In *Stroud's Judicial Dictionary* (volume 5, fourth edition), we find the following observation : "A 'warehouse', in common parlance, certainly means place where a man stores or keeps his goods which are not immediately wanted for sale." In 1751, on Clerks of Assize Act, 1698 (10 Willz c. 12), it was held that 'warehouses' meant 'not mere repositories for goods but such places where merchants and other traders keep their goods for sale in the nature of shops, and where customers go to view them.

It must immediately be mentioned that this is not a common parlance meaning but a meaning given to a warehouse referred to in Clerks of Assize Act, 1698. In *Black's Law Dictionary* (fifth edition), 'warehouse' has been described as a 'structure used for the reception and storage of goods and merchandise'. It further states that 'the term may include any structure used to hold goods, stores or wares temporarily or for a length of time'. *Aiyar's Judicial Dictionary* (ninth edition), defines 'godown' as a storage, or warehouse. According to that dictionary, a 'warehouse' is a place licensed for the storage of goods. *Halsbury's Laws of England* (fourth edition), Note 3 to paragraph 428 on pages 204 reads as under :

"'Warehouse' means a place used for the storage of goods, even temporarily, as in a dock transit shed : A storage place which is ancillary to be a business which is wholly or substantially retail is not a warehouse : A room in the basement under retail sale-rooms used for storing goods temporarily until wanted in the sale-rooms was held not to be a warehouse in *Burr v. William Whiteley Ltd.* [1902] 19 Tax LR 117. These cases are not to be taken as laying down an absolute rule of law that no building can be a warehouse if it is connected with a retail business alone; it is possible even in a retail business to have a building which may be in the fullest sense of the term a warehouse."

It will appear from the above dictionary meanings of 'godowns' and 'warehouses' that both these terms are synonymous and interchangeable. The common parlance meaning which can be attributed to godowns or warehouses is that they must be used for the purpose of storage of goods even for a temporary period [see *CIT v. District Co-operative Federation* [2004] [271 ITR 22](#) (All.)]. Shops in which wholesale or retail business in cloth is carried on cannot, therefore, come within the meaning of 'godowns' or 'warehouses' - *CIT v. Ahmedabad Maskati Cloth Dealers Co-operative Warehouse Society Ltd.* [1986] [162 ITR 142](#) (Guj.).

The use of facility solely for the purpose of storage or display of goods or merchandise does not constitute PE, in terms of paragraph 4(a). If such storage is not the only but also some other activities carried on by the enterprise in the warehouse, it would constitute a PE, for example, modifications, relabelling. The warehouse may be the real centre of activity, in the absence of any other place of business.

Permanent establishment - A mine, an oil or gas well, a quarry and any other place of extraction of natural resources

11.19A Sub-paragraph (f) refers to place of excavation or extraction of minerals (mine), gas or oil (well), stone or sand etc. (quarry) as PE. The list is not exhaustive, but illustrative. "Any other place of extraction of natural resources" is a residuary provision covering every place of extraction of natural resources, which may not be identified by such nomenclature as mine, oil or gas well, or quarry. The term may include all places of extraction of hydrocarbon whether on or off-shore. It covers only extraction of natural resources and not exploration.

Thus, a drilling rig does not constitute a PE; if a well is drilled only in six months, but if production begins in the following months the well becomes a PE as of date (see para 70, Technical Explanation, US Model Convention).

A place for extraction of natural resources constitutes a PE, if it is place through which the business of extraction is exercised. The mere ownership of such a place is not sufficient, unless it is used for the exercise of the business of extraction.

Permanent establishment - Construction PE - Building site, construction, installation or assembly

11.20 Paragraph 1 of article 5 sets out a general definition. Paragraph 2 gives an inclusive definition. Paragraph 3 prescribes a limitation. A building site or assembly or installation project constitutes permanent establishment if it exists for more than a specified period. Paragraph 3 does not extend the scope of the general or inclusive definition. It sets out a different criterion, the permanence test replaced by duration test. It is intended to apply in respect to

cases falling under paragraphs 1 and 2 and to provide that in a class of such cases, the definition is not to apply unless the requirement regarding the period of continuance is fulfilled, though its wording being ambiguous cannot be precisely correlated to one or the other items mentioned in paragraph 1 or paragraph 2. In neither of these the word "site" or "project" is used. Even for such absence, a site or project could be PE in terms of the general definition or fall within the ambit of the listed items of the inclusive definition. But it could not be so taken if such site or project continues for a less than the prescribed period. The element of permanency in relation to site or project or the activities would be attracted if it continues for a period more than the specified.

The permanence test is replaced by duration test. A site, project or activities is taken PE "only" if it lasts for six months (twelve months OECD Model). For other places falling under paras 1 and 2, it may be of shorter period; no rigidity about the duration of their existence. But building sites etc. do not enjoy flexibility. The period of existence has to be more than six (twelve) months.

A building site, construction, assembly or installation project is the place of business. The word "site" means the local position of building to be constructed. The project (construction, assembly or installation), *i.e.*, planned undertaking also requires specific place for performance. The place of business under the construction clause is the physical location of a building site or project, which must last for more than six months (twelve months, OECD Model)

Paragraph 16 of the OECD commentary on article 5 provides:

"This paragraph (paragraph 3) provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity."

Any place of business establishment which is related to or associated with the activity of building, construction or installation should be in existence for a specified period before it qualifies to be designated permanent establishment. It is irrespective of the fact that such a place independently would have been eligible to be so taken. For example, a workshop, or a factory, or a place of management, which may be necessary as incidental or subsidiary to act as "feeding" to the activity of construction etc., has to be present for the specified period, though these establishments are enumerated to be permanent establishment in paragraph 2. Such feeding activities have to be looked at in the context of the construction of building or installation or assembly or a project which activity could be taken permanent establishment if it lasts for more than the specified period. These are for all intent and purposes building sites having resemblance and characteristics of the establishments mentioned in the paragraph. Such resemblance is coincidental.

Permanent establishment - Supervisory activities in connection with building, construction or installation project

11.20-1 Supervisory activities in connection with building site, construction, installation or assembly project are also deemed to be permanent establishment, which are not so deemed under the OECD model. Para 17 of the OECD Commentary, however, provides that on site planning and supervision is a construction activity (matter discussed later in para 11.20-4).

Permanent establishment - Minimum threshold period of existence for the building site, construction assembly or installation project

11.20-2 Building site, construction or similar activities constitute is a form of doing business. The OECD Model Convention imposes a time limit of 12 months for an assembly project to constitute a permanent establishment. These activities, as a consequence of great advancement in modern technology result in generation of income if undertaken for a very short period, much shorter than the said period of 12 months. The developing countries have, therefore, been wanting the curtailment to a shorter period and some, even no prescription of any time limit in the same manner as relating to the activities of artists, athletes and public entertainers under article 17 of the OECD Model Convention, which activities are taxed at the place where these are performed irrespective of their duration. Originally, the limitation of period on the presence of an activity was thought necessary because some time is needed to prepare some foundational work or to initiate preparatory or auxiliary operations before an enterprise

could establish itself for generating income. Such work are exploratory in nature and may not be a source of income. It was thought that the concept of 12 months may introduce certainty into the tax field so that investors could avoid disputes, administrative difficulties and expenses in determining tax liabilities by them.

As a compromise between the two extreme views, the UN Model lays the limit of 6 months. The Model, while limiting the duration of period to six months, expands the term 'building site or construction or assembly project' to include 'installation project' or 'supervisory activities'. The UN Group also added that a permanent establishment also includes furnishing of services by an enterprise through its employees or other personnel where these activities continue, for the same or a connected project, within the country, for a period aggregating more than six months within any twelve-month period. Any place of business which is related or associated with activity of building construction or installation should be in existence for a specified period before it qualifies to be designated permanent establishment, irrespective of the fact that such a place independently would have been eligible to be so taken. For example, a workshop, or a factory or a place of management which may be necessary as incidental or subsidiary to act as 'feeding' activity to the activity of construction, etc., has to be present for the period specified in the agreement, though these items are enumerated to be permanent establishment in sub-paragraph 2. Such feeding activities have to be looked at in the context of construction of building or installation or assembly or a project which activity could be taken permanent establishment if it lasts for more than the specified period. These are for all intent and purposes building sites having resemblance and characteristics of the items mentioned in the sub-paragraph. Such resemblance is coincidental.

Construction PE is available for the contractor who undertakes the contract or the project for others and not available if undertaken for the construction or installation project by the taxpayer for its own office to do business through it.

In *Advance Ruling A. No. 11 of 1995, In re* (1997) [228 ITR 55](#) (AAR), the Authority for Advance Ruling held that a building site or construction, installation or assembly project would constitute a PE only if it were to continue for a period in excess of 183 days and that since the Singapore company had only worked on the oil or gas well and the oil well was not owned or operated by it, its case would be covered under the clause relating to building site, etc., and there would be PE in India only if the duration exceeds 183 days which was not the case before the AAR. The AAR held that since the Singapore company did not have PE in India, its Indian income would not be taxable, even though such activities took place within Indian territory and the profits therefrom would have been chargeable to tax under the Act, in the absence of DTA.

The building site etc., cannot be taken permanent establishment if the duration of its existence falls short of the prescribed period. The Authority for Advance Ruling held as follows in *Advance Ruling P. No. 24 of 1996* [1999] [104 Taxman 377](#) (AAR - N. Delhi) :—

"A 'construction, installation or assembly' project cannot be treated as permanent establishment, unless it continues for a period of more than six months, even though it might otherwise fulfil the definition contained in paragraph (1) or (2)."

In that case an Indian public sector corporation had entered into a contract with a Korean company for laying down and commissioning a trunk pipeline in the territorial waters of India. The Korean company in turn entered into a contract with an Indian company and another company B, incorporated and resident of Netherlands, in respect of some of the items of work to be performed by it under the main contract. The Indian company, however, entered into a further sub-contract with one M/s. H which was also incorporated and resident of Netherlands. The sub-contracts related to pipelines under the sea for the said project. The project undertaken by B was completed within a period of 27 days and that undertaken by H, within 68 days. The question arose whether the revenues earned by M/s. B, a tax resident of the Netherlands, from the contract entered into with Korean company is taxable in India, in terms of article 5 of the Agreement for Avoidance of Double Taxation between India and the Netherlands. Similar was the question with respect to H. Both the companies contended that the activities undertaken by them fall within their regular business activities and, thus, profits are not taxable as they have no permanent establishment situated in India. The Authority observed that the contractual activities were carried out through a shipping vessel, duly equipped and brought into the Indian territory and was therefore a fixed place of business of the applicants from which they were carrying on business transactions (paragraph 1 of article 5 of the said agreement). But paragraph 3 of article 5 prescribed minimum period necessary for such establishment and in the case before them that period fell short of that period, it did not constitute permanent establishment. The Authority observed as follows:—

"The expression 'fixed' contains in itself the indication of a time limit for the existence of the place business. This is quite independent of the specification of the limit under clause (i) of paragraph (2) and in paragraph (3). In relation to certain specified types of business, the articles spell out different minimum periods necessary to consider them as permanent establishment - 'six months', 'period or period aggregating to more than six months within any 12 months period', 'twelve months' and '183 days' in the USA model, the UN model, the OECD model and the treaty under consideration. But, even quite independent of these specific paragraphs the expression 'fixed place of business' itself imports that the place of business should exist for some reasonable period sufficient to establish a nexus with the place of operations, though what that period should be would depend on the individual facts of each case."

Thus, an installation or assembly project is to be treated PE, if its duration exceeds the prescribed limit. If it does not so exceed, no part of the profit arising from the activity is taxable in India, even though the activity took place within Indian territory and profits therefrom would have been chargeable to tax in India but for the tax treaty - *Advance Ruling A. No. P 11 of 1995, In re* [1997] [228 ITR 55](#) (AAR) and *Brown and Root Inc. v. CIT* [1999] 237 ITR 156 (AAR).

11.20-2a BUILDING SITE ETC. - PERIOD OF SIX [BKMEND]MONTHS, DETERMINATION - A building site would be taken to be PE if it continues for a period of more than six months (twelve month OECD Model). The word "continue" suggests the period from the date when work begins till it is completed or abandoned. There are two end points; the date on which work begins and the date on which completed or abandoned. Seasonal or temporary suspension will not be taken out of account. Six months period is the period intervening between when the contractor begins work and when completed or abandoned, notwithstanding suspension due to weather or non-availability of material or labour. Paragraph 19 of the OECD Commentary on Article 5 clarifies by giving an illustration :

"Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of bad weather conditions or a lack of materials but resumed work on 1st February the following year, completing the road on 1st June, his construction project should be regarded as permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project sub-contracts part of such a project to other enterprises (sub-contractors), the period spent by a sub-contractor working on the building site must be considered as being time spent by the general contractor on the building project. The sub-contractor has himself a permanent establishment at the site if his activities there last more than twelve months."

A PE is established as soon as preparatory business activities are commenced. Preparatory activities must be distinguished from preliminary activities such as visiting for site or negotiation. Preparatory activities will lead to a core business activity within a short period of time. After preliminaries having been completed and before the actual physical work commenced, some activities are undertaken preparatory to such commencement and performance of the project, such as delivery of equipment or building material or visit of the employee at the site. The time period commences from the first preparatory activity ; preparatory activities will lead to a core business activity within a short period. Similarly, the time period ends when the last employee departs or the equipment removed from the site. Temporary suspension or interruption of work would not have any effect on the run of the time period.

If the twelve-month threshold is exceeded, the site or project constitutes a PE from the first day of the activity. Time spent by the sub-contractor is considered the time spent by the contractor. However, to determine whether the sub-contractor has a PE, his activities on the site must last for the said prescribed period, interruption notwithstanding (*see* para 72, Technical Explanation, US Model Convention) [also refer to para 11.20-40]

11.20-2b PROJECTS - COHERENT WHOLE, COMMERC[BKMEND]IALLY AND GEOGRAPHICALLY - A series of contracts or projects by a contractor that are interdependent both commercially and geographically are to be treated as a single project for the purpose of applying the time-period threshold test. For example, the construction of a housing development would be considered as a single project even if each house were constructed for a different purchaser. Several drilling rigs operated by a drilling contractor in the same sector of the continental shelf also normally would be treated as a single project. The time period relates to a single project. If a part of a project is undertaken at one place and the other at another, the total period spent on the whole project is to be taken into account to determine the threshold period of six months (twelve months). The nature of the project may be

such as to require relocation of the contractor's activity, as for instance construction of a road. Such relocations may not be taken as a separate projects. The project is one and regarded as PE, if, as a whole, it lasts for more than the threshold.

In determining how long the site or project has existed, no account should be taken of the time previously spent by a contractor concerned on other sites or projects which are totally unconnected with it (*see* OECD Commentary, article 5, para 18). It means that tasks at other sites or other projects are taken to be single unit if they are sufficiently connected, economically and geographically. Thus, each construction site is to be considered as one project as the starting point (*see* Excavation 1939 RFH in R STBI 1939) unless economically and geographically connected. Several contracts are taken to be one project if there is unity of execution, *i.e.*, they are carried out simultaneously or directly one after the other without interruption (for example, construction of row of houses for several persons under as many contracts) or carried out in different places but being part of one project (for example the construction of a highway). Different tasks under one contract are also treated as one project, unless they are totally unconnected.

Technical Explanation of the US Model Income Tax Convention states as follows in para 71:

"The twelve-month test applies separately to each site or project. The twelve-month period begins when work (including preparatory work carried on by the enterprise) physically begins in a Contracting State. A series of contracts or projects by a contractor that are interdependent both commercially and geographically are to be treated as a single project for purposes of applying the twelve-month threshold test. For example, the construction of a housing development would be considered as a single project even if each house were constructed for a different purchaser. Several drilling rigs operated by a drilling contractor in the same sector of the continental shelf also normally would be treated as a single-project."

Different tasks under one or several contracts should be coherent whole commercially and geographically (OECD Commentary, article 5, para 18), *i.e.*, they are connected as far as preparation or planning or unity of execution is concerned and also in geographical terms. Commercial coherence is presumed if the projects are parts of the same building, drilling rigs or ship a building site is regarded as a single unit, even if it is based on several contracts (OECD Commentary, para 18) ; and geographical coherence, if the tasks are performed at the same place though not necessarily in the sense fixed to the soil but in the sense of geographical identification as for example construction of roads, bridges or canals, the laying of pipelines and excavating and dredging.

Coherent "whole", "commercially" and "geographically", is the requirement for the several contracts to be taken as a single project. Commercial coherence and geographical coherence have to be cumulative. Tasks under several contracts if there is unity of execution are to be identified as one project. For example, as illustrated by the OECD Commentary, construction of row of houses based on orders by several persons. Tasks under the same contract if they are interconnected also constitute a single project as explained by the OECD Commentary (article 5, para 18). "The twelve months threshold has given rise to abuses. It has sometimes been found that enterprises (mainly contractors or sub-contractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of continental shelf) divide their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group". To be coherent whole, according to Vogel, the tasks have to be performed at the same place and for the same client. For example, drilling of test wells at different places, or construction of fast food stores at different places, for the same client and under the same contract may constitute commercially interrelated projects. A close relationship between the projects, geographically and commercially, may be suggestive of those being one.

If several projects and contracts are commercially and geographically connected, the time period between the commencement of the first and the last activity should exceed six months (twelve months OECD Model) for the constitution of PE.

11.20-2c INCOME NOT CHARGED UNDER OTHER HEAD, IF CHARGEABILITY FAILS FOR THE PERIOD FALLING SHORT - If the chargeability as business profit fails because the duration of the PE does not extend beyond the stipulated period, it cannot be enforced by labelling income differently - *Horizontal Drilling International v. CIT* [1999] [237 ITR 142](#) (AAR). If the nature of the income is such that it could be classified as falling under two heads, the matter could be resolved according to the well-established principles that a specific provision will override the general one and that the assessee/subject-matter is entitled to invoke the provisions most beneficial to him, be they the provisions of a treaty or statute - *Brown and Root Inc. v. CIT* [1999] 237 ITR 156 (AAR).

Permanent establishment - Building sitePermanent establishment - Building site

11.20-3 The expression 'building site or construction or installation of project' has not been defined in the OECD or UN Model Convention. "Site" is the location of a building to be constructed. 'Building' in its ordinary and usual meaning is a block of brick or stone covered by a roof - *Makkhan v. Emperor* AIR 1945 All. 81. The ordinary and usual meaning which is contemplated by this expression is any structure enclosing the space within its walls with or without roof, if the structure is designed for inhabitation or shelter, storage, trade, manufacture, worship, business, teaching and the like - see *Edward Keventers (Successors) (P.) Ltd. v. Union of India* AIR 1983 Delhi 376. Building in its general sense is anything built or constructed - see *Salig Ram v. Emperor* AIR 1916 Oudh 109. Thus, an open air swimming pool, or a roofless large stadium constructed at a considerable expense would be building - *Ghanshiam Das v. Debi Prasad* AIR 1986 SC 1998. Anything which is built is a building, such as construction of roads, canals, bridges, the laying of pipelines, and excavating and dredging.

Paragraph 17 of the OECD Commentary on article 5 provides :

"the term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this item, if carried out by the building contractor. However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence."

To construct means to build; to assemble parts; to form a whole; to create. Construction work is the work relating to building, assembling or creating of any thing tangible, such as buildings, roads, canals, bridges, ships or rigs etc. Construction work may be done on the existing object such as laying of asphalt on the existing road or creating a new thing such as a ship or dam. Drilling of wells as an attempt for offshore exploration of oil is also a construction activity. The place of extraction and not of exploration of natural resources is a place of business in terms of clause (f) of para 2 of Article 5.

Construction includes re-construction, repairs and maintenance

Construction includes re-construction. "When the wearing or injury is partial, then the repair is restoration and not reconstruction" (see *Wilson v. Simpson* 9 How, 109 [1850]). And if it is more than that, it is reconstruction. For example, mending some patches on the road because of injury due to rain is repairing, but laying asphalt on the whole of it is reconstruction. Extensive and comprehensive repairs go beyond mere maintenance and be taken as construction work such as work done to carry out repairs on dams and canals [see German Supreme Court case in *Repair* 1957 (BFH in BStB1 1957 III 8)].

Even repair is a constructional activity. Construction includes repair work (see German Supreme Court in *Repair* 1957, BFH in BStB1 1957 III 8). It is because the tasks involved in both are similar. This is explained by an analogy of repairing and stitching a coat. In repairing what are needed is the thread, needle and tailoring skill. These are also required in stitching a new one. The activity involved in both is tailoring. From tailoring point of view, repairing tasks are not different from stitching a new coat. Similarly, in case of a building, repairing tasks are not different from the construction tasks, from the functional point of view. Whether construction of a new item or repairing an already existing one, the activity involved is the construction activity. It is the nature of the activity, from the functional point of view, and not its extent that is important.

Construction includes all activities which contribute to construction

Construction work has been defined by the German Supreme Court in the case of *Hospital* (RFH in RStB1 1942) as all tasks which contribute to the erection of a construction in the broadest sense, above or beneath the surface, provided that such tasks are performed at a construction site. Thus, activities such as demolition, excavation, dredging, erection of barracks for the employees and labour being the preparatory activities which precede the actual construction, contribute to the construction and hence the construction activities.

Supervisory and management activities also contribute to the construction are the construction activities. On-site planning and supervision of the erection of a building is, therefore, a construction activity (see para 17, OECD Commentary, article 5). Only on-site supervision is considered and not any other type. The supervision of construction project is the construction activity. The UN Model Convention so specifically provides. Its article 5(3)

includes "supervisory activities" in connection with construction site or project as construction activities. Planning, supervision or management would be taken to be construction PE if performed in connection with a construction or installation project.

Permanent establishment - ConstructionPermanent establishment - Construction

11.20-4 Construction activity is a complex activity involving the application of technical know-how, material and skill of trained personnel, such as for the purpose of construction of dams, bridges, etc. - *see CIT v. Shah Construction Co. Ltd.* [1983] 142 ITR 696 (Bom.). The six months test applies to each individual site or project. A site exists from the date on which the contractor begins his work, including the preparatory work (as discussed in para 11.20-2a). Temporary suspension of the work or interruptions in the activity on account of non-availability of material or labour or of capital or on account of weather or any other account should be taken into consideration in calculating the period of six months. The site here refers only the presence of the contractor in a country and not usually the geographical location of the permanent establishment within that country. In fact the nature of activity is such in some cases that shifting of 'site' from time to time becomes necessary such as in case of construction of roads or canals or laying out the pipeline. (Please also *see* paragraph 11.20-2a).

Permanent establishment - InstallationPermanent establishment - Installation

11.20-5 Activities relating to installation of machinery or equipment are taken to be permanent establishments. For installation of machinery, the relevance of time limit has no significance if such installation is a part of the contract of sale. If the sale of machinery is subject to its installation and inspection, the sale is not complete till such installation has been done and inspection made. A machinery or equipment could be sold either by its delivery straightaway or by its delivery in the installed form. When the sale is contracted in the latter form, the operation to install it is undertaken as accessory of sale which cannot be likened to the type of activity as gives rise to permanent establishment within the meaning and intent of tax agreements. Thus, the building site or construction or assembly project or supervisory activities in connection therewith could relate either to the transaction of sale of machinery or equipment in the installed form or otherwise. In case of the former, however, no time limit is normally prescribed for being regarded permanent establishment if the charges of such project or activity exceed 10 per cent of the sale price of the machinery or equipment. Thus, it was suggested that the following should be the guideline for the bilateral agreement:

"A building site or construction or assembly project or supervisory activities in connection therewith, where such site, project or activity continues for a period of more than six months, or where such project or activity, being incidental to the sale of machinery or equipment, continue for a period not exceeding six months and the charges payable for the project or activity exceed 10 per cent of the sale price of the machinery or equipment."

This guideline was followed in the Indian tax agreement with Belgium and Finland.

Article V(2)(g) of the agreement with Belgium for the first time provides "... or where such project or activity, being incidental to sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project for activity exceed ten per cent of the sale price of the machinery or equipment." In some cases, however, the monetary limit has not been prescribed as in the agreement with Malaysia.

Permanent establishment - Substantial equipmentPermanent establishment - Substantial equipment

11.20-6 Some of the agreements include in the concept of permanent establishment the substantial use or installation of equipment in a foreign country by, or under contract with the enterprise. The substantial equipment means substantial machinery, which does not include samples used in demonstration to wholesalers and retailers and in training and demonstrations. The substantial machinery or equipment contemplates the use of heavy or large machinery or equipment by such persons as contractors or builders who as is well known, may move such equipment from place to place in carrying out their operations - *Minister of National Revenue v. Sunbeam Corporation (Canada) Ltd.* 15 DTC 1053/16 DTC 1390.

Mere presence of substantial equipment belonging to a foreign enterprise in the source country will not lead to the existence of permanent establishment. The equipment must be used or installed for or under contract with the foreign enterprise. A single piece of heavy machinery may constitute 'permanent establishment'. It need not necessarily mean a large quantity of equipment—*Minister of National Revenue v. Sunbeam Corporation (Canada) Ltd.* 15 DTC 1053/16 DTC 1390.

In *Canadian Pacific Ltd. v. The Queen* 30 DTC 6120, it was held that "mere use of its freight cars in the US by all other rail roads does not itself constitute a permanent establishment". The following propositions could be inferred:

- ...■ Substantial equipment need not necessarily mean a large quantity of equipment; a single piece of heavy machinery may constitute a PE;
- ...■ Equipment used for demonstration or advertisement excluded;
- ...■ Equipment need not be used or installed by, or under a contract with, a foreign enterprise.

Mere presence of equipment, even automated, does not constitute PE, unless some business is carried through the equipment. It may be done through the agency of human efforts. The operation of a vending machine is an example.

Permanent establishment substantial equipment - Automated equipmentPermanent establishment substantial equipment - Automated equipment

11.20-7 The OECD commentary discussed entrepreneurial activities existing in the operation of automatic equipment, for example, vending machines. The mere setting up of the machine for lease to an operator does not constitute a PE. If the machines are operated by the enterprise itself or by a dependent agent for its own account, then a PE can be assumed. The European Court of Justice had occasion to consider whether such use of a machine amounts to a PE. (Judgments of the European Tax Court 1985, p. 251 *Berkholz* case 168/84). It held that the definition of the fixed place of business presupposes both physical resources as well as personnel who assist the entrepreneur in the use and the implementation of the physical resources. The court held that the fixed place of business could be a piece of equipment, such as a vending machine. It should, however, be permanently installed and it requires the employment of energy for its operation.

In another case, the German Supreme Court held that a Dutch Corporation that supplied oil and oil products through underground pipelines in Germany constituted a German PE. German oil companies maintained delivery stations that supplied the companies with oil. The necessary oil pressure for the transportation of the oil was supplied in the Netherlands. The Dutch company had no employee in Germany. The contractors did all maintenance and repairs of the pipeline in Germany. The court held that fully automated equipment constituted PE (The Pipeline Decision, European Taxation, Feb., 1999, 67).

Though the said decision was based on the old Germany-Netherlands treaty which had presence of an asset as one of the PE tests, the decision is still relevant. Physical resource, such as an equipment or automated machines would constitute PE if there are personnel who assist the entrepreneur in their use and implementation. For carrying on business human input is necessary, either by employees or dependent agents.

Permanent establishment - Server whetherPermanent establishment - Server whether

11.20-8 Server is a machine that makes services available on a network to client programmes.

Server, as machine, performs some functions. Income attributable to such functions is attributed to server, as was done in *Piedras Negras v. Comr.* 43 B.T. A 297 (1941) wherein the source of broadcasting revenue was determined by looking to where the equipment, *i.e.*, radio station's studio and the power plant were located and where its personnel performed services. Sourcing of income attributable to functions performed by the server is similarly determined by looking at where it is located and its personnel performed services.

A file server makes file available. A WAIS server makes full-text information available through the WAIS (although WAIS uses the term source interchangeably with server) A web site server contains the information required to process the order. World Wide Web is system of internet servers that support specially formatted documents. The documents are formatted in the language called HTML (Hyper Text Markup Language) that supports links to other documents, as well as graphics, audio, and video files. This means that one can jump from one document to another simply by clicking on hot spots. Internet is thus a web, with no centre. Thus in a simple purchase of goods through internet through a mail order catalogue, the internet cuts out the operator middleman. It obviated the need for physical goods and services in a chain of distribution. The disk and the requisite information could be sighted any where. Finally, the internet eliminated the need of the people to be physically present in one place rather than another. Server may not on that account be taken as an establishment within the definition of article 5. That definition insists upon physical presence. A server is not such a presence, in strict sense. It is space on the disk. Otherwise also it may not be taken as PE. As a medium of advertising, it falls within the exception as contained in paragraph 4. Sub-clause (a) thereof except the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise. Sub-clause (e) exempts the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. In some cases geographical locations where the server is located may constitute permanent

establishment. It is only when the server conducts the core functions of the taxpayer's business. The matter is discussed later.

Web site or the Internet service provider (ISP) does not constitute PE. A web site is a mere combination of software and electronic data. It is not a place of business. It cannot, therefore, be a PE. Similarly, ISPs which host web sites will generally not create a PE, since such service providers will not be dependent agents of the e-retailers whose web sites they have hosted. On the other hand, the server on which the web-site is stored, is a piece of equipment which has a physical location and may constitute a fixed place of business of the enterprise which operates it. If an enterprise carrying on business through a web-site also owns and operates the server in which the web site is stored and used, the server could constitute PE. But if a mere hosting arrangement exists, then such server cannot be PE. According to the OECD model, a business of an enterprise can be carried through automatic equipment, such as vending machine. In the context of e-commerce, the issue is whether a business of an enterprise may be said to be wholly or partly carried on through a server. The matter is discussed in detail, later.

Permanent establishment - Furnishing of services - Service PE

11.21 The concept of a service PE finds place in the UN Model. It is constituted if the enterprise renders services through its employees provided services are rendered for a specified period (*see DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) (SC)]. Sub-paragraph (b) of paragraph 3 of the UN Model includes within the ambit of permanent establishment furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose if the activities continue for a period or periods aggregating more than six months within any 12 months period. Service is provided when the economic benefit associated with the transaction flows to the recipient. Provision of some services, other than services in connection with the purchase of goods, may be considered as a separate business activity. The issue relating to services besides somewhat distantly trade related ones like intellectual property rights and trade related investments poses problem about its trading. Services can neither be traded nor can be stored and they do not physically cross border the way goods do. They are fundamentally different from other kinds of economic activities. The expression "services" is difficult to be defined precisely. At the broadest level of abstraction, services comprise the "tertiary sector" of economy, the primary sector being mining and farming, and the secondary, manufacturing. The residual category covers heterogeneous assortment of activities ranging from consumer services such as haircuts to sophisticated producer of services such as data processing. In recent years, technology advancement particularly in the area of communication and computerisation has permitted more timely and efficient production, delivery and consumption of services on a world wide scale. Technology aims at and results in providing to the people means of producing goods, rendering services and simply living their lives in comfortable and least consuming ways. It denotes some knowledge, experience, and skills necessary for the manufacturing of a product and for establishing an enterprise for the purpose. It not only refers to producing goods but also to ways of fulfilling needs and deriving satisfaction. The development of society is directly associated with the development of technology, for instance, transformation from a society of basic needs to the society of tangible needs, to the society of intangible needs and on to the society with a set of intangible needs of communication, information and human interaction. The distinction between goods and services is blurred in the present context.

Services - Types of

Services which are provided range from the relatively common place to complex technical associated with transfer of intangibles. They are of the nature of—

- **professional services** - such as legal, accounting etc.
- **material services** - such as providing electric power, water, transport, telephones, etc.
- **trade services** - such as banking, insurance, shipping, consultancy, telecommunication, data processing; etc.
- **management services** - such as administrative, technical or commercial services

Service - A product

What is essential for an article to become goods is its marketability. The test is not whether the property is tangible or intangible, but whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred or delivered, stored, possessed etc. Goods is manufactured when some raw material is processed to a final marketable product. When intangibles - ideas, plans, procedures, formulas, etc. are transformed or converted into different state or form, such transformation or conversion is not 'manufacturing' because no

'material or thing' has been transformed or converted (*see* Supreme Court of Ohio in *Interactive Information Systems, Inc. v. Limbach* [1985] 18 Ohio st. 3d 309; 480 N. E. 2d 1124). Such conversion or transformation does not result in the "goods" manufactured but an item produced which can be delivered and sold as services. Services are the product of intellectually processed information and knowledge; the input (raw material) being the information or the knowledge which is intellectually processed resulting in a final product. The quality of skill is not the product but when processed resulting in something discernible and marketable it becomes product. In *Winter v. Putnam* [938 F 2d 1033 (9th Cir. 1991)], the quality of information regarding mushrooms was not regarded product even though the encyclopaedia containing the information was regarded goods. The intellectual input is not, but the result of its application is, the product. In *Advent Systems Ltd. v. Unisys Corporation* [925 F.2d 670 (3rd Cir.)] it was contended before the court in the United States that software referred to in the agreement between the parties was 'product' and not 'goods' but intellectual property outside the ambit of the Uniform Commercial Code. In the said Code, goods were defined as 'all things (including specially manufactured goods) which are movable at the time of identification for sale' holding software as 'goods' the court held:

"Computer programs are the product of an intellectual process, but once implanted in a medium are widely distributed to computer owners. An analogy can be drawn to a compact - disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not a "goods", but when transferred to a laser- readable disc becomes a readily merchantable commodity. Similarly, when a professor delivers a lecture, it is not a goods, but, when transcribed as a book, it becomes a goods"

The term "goods" as used in article 366(12) of the Constitution of India is very wide and includes all types of movable properties, whether those properties be tangible or intangible [*see Tata Consultancy Services v. State of Andhra Pradesh* [2004] [271 ITR 401](#)(SC)]

The expression "provision of services", therefore, refers to services which are dealt with similarly as goods. The common characteristics of goods and services are that they are supplied at a price to cover the costs and generate profit or income (*see Lucknow Development Authority v. M. K. Gupta* [1994] 80 Comp. Cas. 714 (SC)]

Service - A solution

Some services are traded as goods are traded. Trade does not mean merely traffic in goods, *i.e.*, exchange of commodities for money or other commodities. It would also mean trade in services such as transport, banking, insurance, communication etc. Such services are also goods (*see R. M. Investment Trading Co. v. Boeing Co.* AIR 1994 SC 1136). The emphasis has now been shifted from developing products to providing solutions. This involves expanding the conventional definition as a physical entity bound by a category to a total service or solution as happened in the car industry. Historically, cars were sold as stand-alone products. Gradually service guarantees were built in. Now car purchase financing has been built into the product package. Financial services are now sold as financial products just like soaps, shampoos or cornflakes. The two classical international examples of successful retail marketing of financial products are Merrill Lynch in the United States and the Nomura in Japan. Investment products are to be marketed like fast moving consumer goods, to the investors. Financial markets in all its facets of products portfolio, distribution and communication is catching up with the product marketing and is changing to keep in touch with consumer needs.

Service and goods transaction - Distinction

The basic distinction between a service transaction and the goods transaction is whether the customer acquires property from the vendor. A transaction is treated as service transaction if the ownership of the property is not transferred. If a customer engages the vendor to create an item of property that the customer will own from the moment of its creation, then no property will have been transferred from the vendor to the customer. The transaction is the transaction of service, irrespective of the vendor having made use of his property and transferred it in the process. The predominant nature of the transaction is not the transfer of the property itself but the provision of services. Mere passing the property in an article or commodity during the performance of the transaction of rendition of service does not render the transaction to be a transaction of sale. Even in a contract purely of service, it is possible that articles have to be used by the person rendering the service and the property may pass to the other party. That would not convert the contract into one of sale of these materials. For example, in a contract for repairing a coat the parties cannot be regarded as having entered into a contract for the sale of thread which was stitched in the coat and which thereby become part of the coat in the process of carrying out repairs. The service provider through the exercise of his particular talent and skill creates a unique result for the customer and

paid for his such unique contribution, the value of property passed in the process of rendering services having little intrinsic value.

Provision of services and sale or rental of property- No distinction

There is no distinction between payments for the provision of services and the payments for the sale or rental of property. Both fall under article 7 (business income). But if it is of the nature of technical service involving the use of technology and technical know how, it falls under article 12 (royalty). In that case, technology is considered to have been made available when the person acquiring the service is enabled to apply the technology embedded in the services provided to him. Technology is thus made available to the customer. The mere fact that the provision of the service may require technical input by the person providing the service would not *per se* mean that the technology has been made available. Similarly, the use of the product which embodies technology, shall not *per se* constitute technology being made available.

Services - traded as goods (Trade services)

Software may be sold like manufactured products bundled in CD. Internet has made it possible to sell it as services. Many software majors (e.g., IBM, Sun, Red Hat, Trend Micro) are now offering their products as services and asking consumers to pay service charges rather than one-time licence fees. Many other software vendors are experimenting with the concept of delivering "services" through internet and doing away with software installation at the consumer end and thus shifting from upfront licence revenue to long-term subscription. Companies are looking to access software functionality as a service with a usage-based pricing, which could be compared to the pricing of utilities and infrastructure services such as telecom, real estate or transport. IBM India has recently launched Software as Services (SaaS), which provides remote access to business software as service.

Computer program is the product of an intellectual process and is copyrightable as intellectual property. But once implanted in a medium, they are widely distributed to computer owners. An analogy can be drawn to a compact disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not "goods", but when transferred to a laser- readable disc becomes a readily merchantable commodity (*see Advent Systems Ltd. v. Unisys Corp.* [925 F.2D 670 (3rd. Cir. 1991)] A disc or tape containing a program is tangible in character, though its content is the reproduction of the product of an intellectual effort. The disc or the tape for wide distribution is a copyrighted article, while its content is copyrightable intellectual property. The Supreme Court of Ohio in *Interactive Information Systems, Inc. v. Limbach* [1985] 18 Ohio st. 3d 309; 480 N.E. 2d 1124, distinguished that tapes were tangible, while computer information was intangible. The courts that have found that computer software to be tangible have based their decisions on the fact that the computer program was coded on a tangible medium, such as computer tape [*see Citizens and Southern Systems, Inc. v. South Carolina Tax Commissioner* [1984] 280 S. C. 138; 311 S.E. 2d 717] and *Comptroller of the Treasury v. Equitable Trust Co.* [1983] 296 Md. 459; 464 A 2d 248 (finding that only non-customised computer software is tangible property)]. But the essence of the transaction in the sale of computer software is the purchase of intangible information [*Compuserve Inc. v. Lindley* (535 N. E. 2d 360)]. The essence-or-purpose-of-the-transaction test is to be applied to determine whether the software is tangible or intangible property. In a non-customised software, the purchaser neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function.

In *St. Albans City and District Council v. International Computers* [1996] 4 All ER 481, it was observed :

"During the course of hearing, the word 'software' was used to include both the (tangible) disk onto which the COMCIS program had been recorded and the (intangible) program itself. In order to answer the question, however, it is necessary to distinguish between the program and the disk carrying the program.

In both the Sales of Goods Act, 1979, section 61, and the Supply of Goods and Services Act, 1982, section 18, the definition of goods includes 'all personal chattels other than things in action and money'. Clearly, a disk is within this definition. Equally clearly, a program, of itself, is not."

As regards utility of an instruction manual, it was observed:

"As I have already said, the program itself is not "goods" within the statutory definition. Thus a manual of the program in the way I have described does not, in my view, constitute a transfer of goods. It follows that in such circumstances there is no statutory implication of terms as to quality or fitness for purpose."

A software program is the creation of an intellectual effort. It has been held by the American Courts in *Commerce Union Bank v. Tidwell* (538 S.W. 2d 405); *State of Alabama v. Central Computer Service Inc.* (349 So. 2d 1156);

First National Bank of Fort Worth v. Bob Bullock (584 S.W. 2d 548); *First National Bank of Springfield v. Department of Revenue* (421 NE 2d 175); *Compuserve Inc. v. Lindley* (535 N.E. 2d 360) and *North East Datacom Inc. et al v. City of Willingford* (563 A 2d 688)—

- that by sale of the software programme the incorporeal right to the software is not transferred ;
- that incorporeal right to software is the copyright which remains with the originator. What is sold is a copy of the software;
- that the original copyright version is not the one which operates the computer of the customer but the physical copy of that software has been transferred to the buyer;
- that when one buys a copy of a copyrighted novel in a bookstore or a recording of a copyrighted song in a record store, one only acquires ownership of that particular copy of the novel or song but not the intellectual property in the novel or song.

The information contained in the software program can be introduced in the user's computer by several different methods, namely, (a) it could be programmed manually by the originator of the program at the location of the user's computer, working on his own instructions ; or (b) it could be programmed by a remote programming terminal loaded miles away from the user's computer, with the input information being transmitted by telephone; or (c) more commonly the computer could be programmed by use of punch cards, magnetic tapes or discs, containing the program developed by the vendor. Vendor also provides manuals, services, and consultation designed to instruct the user's employees in the installation and utilization of the supplied program. The American courts [*Commerce Union Bank v. Tidwell* (538 S.W. 2d 405); *State of Alabama v. Central Computer Service Inc.* (349 So. 2d 1156); *First National Bank of Fort Worth v. Bob Bullock* (584 S.W. 2d 548); *First National Bank of Springfield v. Department of Revenue* (421 NE 2d 175); *Compuserve Inc. v. Lindley* (535 N.E. 2d 360) and *North East Datacom Inc. et al v. City of Willingford* (563 A 2d 688)] held:

- that even though the intellectual process is embodied in a tangible and physical manner, that is on punch cards, magnetic tapes etc., the logic or intelligence of the program remains intangible property;
- that it is this intangible property right which is acquired when computer software is purchased or leased;
 - that what is created and sold is information and the magnetic tapes or the discs are only the means of transmitting these intellectual creations from the originator to the user;
 - that the same information could have been transmitted from the originator to the user by way of telephone lines or fed directly into the user's computer by the originator of the program and that as there would be no tax in those cases merely because the method of transmission is by means of a tape or disc, it does not constitute purchase of tangible personal property and the same remain intangible personal property ;
 - that what the customer paid for is the intangible knowledge which cannot be subjected to the personal property tax.

The American courts [*South Central Bell Telephone Co. v. Sidney J. Barthelemy* (643 So. 2d 1240); *Comptroller of the Treasury v. Equitable Trust Company* (464 A.2d 248); *Chittenden Trust Co. v. Commissioner of Taxes* (4645 A.2d 1100) ; *University Computing Company v. Commissioner of Revenue for the State of Tennessee* (677 S.W. 2d 445) and *Hasbro Industries, Inc. John H. Norberg, Tax Administrator* (487 A.2d 124)], held that when stored on magnetic tape, disc or computer chip, the software or set of instructions is physically manifested in machine readable form by arranging electrons.

Services are traded as goods are traded

Services are traded as goods are traded. The trade issue centres on the activities that can profitably be offered across borders, either through trade or through direct investment in the target market. Among these are banking, advertising, transportation, insurance, communication, data processing, construction, engineering, entertainment and tourism. Many trade services tend to intensively use technology and capital. For an international service transaction to take place, one or more combinations of the following categories move across borders; goods, capital, persons, and information. Each can cross frontiers to receive or provide a service, e.g., the movement of person can involve labour or consumers. Goods can cross borders to receive a service (e.g., repair and processing services) or to provide a service (i.e., international leasing of machinery or chartering of transportation equipment). This is to be distinguished from trade in services. Intra-country transactions are possible only in some of this. In services that are exportable, the developing countries are clearly at a disadvantageous position in respect of most

areas, possibly with the exception of tourism. Presently a wide variety of information-intensive services can be provided to customers abroad through international flow of information or transborder data flows (banking services, product design and access to information stored in data base).

Material and professional services

The present emergence of services as a major force is the result of a number of factors. The emphasis has been shifted from manufacturing to services. The trend towards greater specialisation and the concomitant economies of scale in the service sector have become apparent in the international economic transactions. There are two kinds of services, namely, material services and professional services. Material services are not services which depend wholly or largely upon the contribution of professional knowledge, skill, dexterity for the production of a result. They are not given to individual by individual. They involve an activity carried on through the cooperation between the employers and the employees to provide the community with the use of something such as electric power, water, transport, telephones and the like. In providing these services, there may be employment of a trained man and even a professional man but the emphasis is not what these men do but upon the productivity of a service organised as an industry and commercially valuable. The services of a professional man involving benefit of individuals according to their needs such as doctors, lawyers, solicitors, etc., are easily distinguishable from an activity such as transport service. The latter is of commercial character in which something is brought into existence quite apart from the benefit of particular individuals—*Management of Safdar Jung Hospital v. Kuldip Singh* AIR 1970 SC 1407.

Where there is a systematic activity organised by the cooperation between the employer and the employee for production of goods and services calculated to satisfy human wants and wishes is a material service because the focus of the activity is functional. The decisive factor is the nature of the activity with the special emphasis of the employer and employee relation and if the organisation is a trade or business organisation, it does not cease so to be because of the provision of the services by the undertaking. The material services are placed at par with industry. Therefore, services relating to banking, insurance, shipping, consultancy, manpower, telecommunication, data processing would mean that the person who indulges in such activities have been carrying on trade or business and the result obtained may be on account of employment of intellectual skill with the association of labour and employees. The result obtained because of the application of such skill may not be tangible as in the case of manufacturing or production where goods are produced with a different identity from the raw materials. Thus, the payments made to an enterprise in respect of furnishing by that enterprise services as a result of that activities of the employees or other personnel, are therefore, subject to article 5 and be taken as profits of the permanent establishment.

Management services

Provision of services also includes management or administrative services. They cover those relating to administrative services (such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal, factoring), financial services (such as supervision of cash flow and solvency, capital increases, loan contract, management of interest and exchange of rate risks, and refinancing) production and marketing services (such as assistance in the fields of production, buying, distribution, and marketing) HR services (such as recruitment and training of staff), technical services (such as associated with the transfer of an intangible property), R&D etc. A combination of these may exist where an affiliate requires the expertise of the parent company to manage its affairs with little or no local input. Any amount paid by one enterprise to another associated enterprise for a transaction which is not a transaction involving the transfer of the tangible property or granting the right to use of the intangible property, is loosely described as management fee. A transaction involving providing services would mean -

- that service has been or will be provided by performance of an activity ; and
- the activity has conferred or is expected to confer a benefit to the related party.

In Australia, Taxation Ruling 1999/1 draws a distinction between non-chargeable and 'shareholding activities' (e.g., parent company shareholder meetings) and a broader range of 'stewardship activities' which may confer bene-fits on the related party (e.g., centralized co-ordination and control of financial management of the group).

Service is rendered when the economic benefits associated with the transaction flows to the enterprise. The taxpayer is to prove that (i) the services have in fact been provided; (ii) the service provider incurred the expenses

while rendering such services; and (iii) the service provided added economic value to the related entity receiving such services.

Management fee is deductible if the services are directly beneficial to the associated enterprise, to the extent it is arm's length. Arm's length for that purpose may be taken in most of the cases as the cost of providing with an additional small margin of profit. The Supreme Court in *DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) observed that transactional net margin method (TNMM) by which net profit margin is computed in relation to costs, is the most appropriate method in the case of service PE. The mark up depends on facts and circumstances of each case and also whether it is non-core or core services. A non-core service includes activities which are non-integral to the profit earning or economically significant activities of the group.

Permanent establishment - Consultancy servicePermanent establishment - Consultancy service

11.21-1 Consulting services are generally provided by an enterprise through its employees. Such services in developing countries often involve very large sum of money and so the developing countries have been arguing that the profits from such services should be taxed by developing countries in certain circumstances. Indian recent agreements contain provision for holding furnishing of services, including consultancy service by a foreign enterprise through employees or other personnel engaged by the enterprise for such purpose, as permanent establishment, but only if the activities continue for a certain minimum period within any 12-month period. The UN Model provides that period to be consisting of six months. The agreement with Indonesia holds it to be 91 days; and Sri Lanka 183 days.

Permanent establishment - Consultancy service - A Ruling of Authority for Advance RulingPermanent establishment - Consultancy service - A Ruling of Authority for Advance Ruling

11.21-2 The Authority for Advance Ruling—*Advance Ruling P. No. 28 of 1999* [1999] [105 Taxman 218](#) (AAR - N. Delhi) debated an issue whether income from rendering services was business income taxable under article 7 or as consultancy service income, under article 12, in the context of the tax treaty with USA. The facts of the cases are these. "AB" is joint venture company in India with 50 per cent of shares, each held by "A", an Indian company and "B" of the US for the production and sale of motor cars and automotive products. The applicant "XYZ" is a company wholly incorporated in USA and is also wholly-owned subsidiary of "B". According to the applicant, its business is principally to provide management and consultancy services to B's subsidiaries or affiliated companies worldwide. As per agreement entered into between AB and XYZ, the latter has to provide executive personnel for the development of general management, finance and purchasing, service, marketing and assembly/manufacturing activities, and AB is required to pay to XYZ as an annual fee equivalent to the costs incurred by the applicant on the employees without any element of profit. The annual fee includes any Indian taxes payable by XYZ in connection with the furnishing of the executive personnel and further the annual fee is to be paid on a quarterly basis. On the basis of the invoice rendered by the applicant to AB. The applicant rendered the invoices to AB for the reimbursement of the expenses for the deputation of personnel and those were paid by AB after deducting 20 per cent as withholding tax. Ruling was sought on the question whether any part of the amount invoiced by XYZ to AB is liable to tax in India. According to the applicant, XYZ was not rendering any services at all to AB or B and since XYZ only designates its employees to work for AB, such lending of the services of its employees is not sufficient to attract article 5(2)(I) (permanent establishment) or 12(4) (Royalties) of the tax treaty. The Authority ruled as follows (head notes):—

"It is difficult to accept the argument that the XYZ is furnishing no services at all to AB. The services rendered by XYZ fall squarely within the definition of "PE" and, subject to their being found to be "technical or consultancy" services, of the expression "included services" in the DTAA. AB is in need of services, call them managerial or technical or anything else, and it finds that XYZ is carrying on a business in the provision of such services to all "B" affiliates. It enters into an agreement with "XYZ" for those services. "XYZ" being a company, can render such services only through human agency and it does so through its own employees. The agreement is, therefore, for the furnishing or rendering of such services, as are covered by the definition, by "XYZ" to "AB". XYZ is not being paid a remuneration for having recruited and deputed efficient employees to serve "AB". It is paid as remuneration, every quarter, the remuneration payable to designated employee. In other words, "XYZ" is being paid for the services rendered by it to "AB" through its employees.

Moreover, "XYZ", under the agreement, has not only to nominate these employees, but is also responsible for their suitability or compensate for the job for which they have been chosen and to replace them in the case of a

vacancy. It has a continuing responsibility under the agreement. If any of the deputed employees resign or are transferred to some other assignment, substitutes have to be provided.

The agreement, but for prior termination by either party, is to be coterminous with the joint venture. Various clauses show that "XYZ" furnishes services to "AB" through the employees and these services continue throughout the duration of the agreement. Therefore, unless the services in question fall under the definition of "included services", that "XYZ" has a PE in India and that the fees received by it in consideration for, and attributable to those services are chargeable as business profits."

In *Morgan Stanley* case ([292 ITR 416](#)), the Supreme Court considered the application of article 5(2)(l) of the Indo-US treaty as regards the work to be performed by deputationists in India as employees of the Indian company. The Supreme Court observed that an employee of the US company when deputed to the Indian company does not become the employee of the Indian company. The deputationist has a lien on his employment with the US company. As long as the lien remains with the US company, the said company retains control over the deputationist's terms and employment. Where the activities of the multinational enterprise entail it being responsible for the work of the deputationist and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multi-national enterprise, a service PE can emerge. On completion of his tenure, a deputationist is repatriated to his parent job. He retains his lien when he comes to India. He lends his experience to the Indian Company as an employee of the US company as he retains lien and in that sense there is a service PE under article 5(2)(l).

Permanent establishment - Service should relate to same or connected project

11.21-3 The furnishing of services should continue for a period aggregating more than six months within any 12-month period, and the nature of the services should relate to the same project or a connected project. The block of 12-month period may not coincide with the fiscal year or the calendar year. The block comprises of twelve months commencing from the date of furnishing services. The 'month' must be taken to mean a period of 30 days—*CIT v. Laxmi Rattan Cotton Mills Co. Ltd.* [1974] [97 ITR 285](#) (All.) i.e., the corresponding date in the next month *minus* one. The aggregate of the period(s) in the block of 12-month period should be taken into account; and if it comes to six months, permanent establishment exists irrespective of whether the period is continuous or broken. Reference to the words 'for the same or connected project' would mean if the services relate to different projects, even for a period more than six months the enterprise rendering services, would not constitute permanent establishment. An enterprise may undertake many unrelated projects for furnishing services and may spend some period on each, the total of which in a block of 12 months may exceed six months, such an enterprise cannot be said to have a permanent establishment in the host country.

Permanent establishment - Place of service

11.21-4 Provision of furnishing of services through employees or other personnel engaged for such purpose is the activity involving expenditure of labour in relation to property. Therefore, some physical presence (personnel and/or assets) of the non-resident is necessary. A person in the business of providing services carries on business at a place where he habitually makes contracts [*Erichsen v. Last* (1881) 8 QBD 414]. In respect of many types of services, the place of performance may assume dominance in determining where the business of providing services is carried on, for example, physical construction services, which is closely tied up with the place of construction.

Software - Whether service or goods

11.21-5 Software could be goods or service, depending upon the facts and the circumstances. The expression goods means all kinds of personal and real property but does not include money or choses-in action and the expression services, any thing which is not goods or money. Chose-in action could, therefore, be taken services. Under the Indian Copyrights Act, 1957, copyright exists in a computer programme as a literary works. Supply of the right to use the copyright in software constitutes a supply of a chose-in action (being a supply of rights enforceable under the Copyright Act) and, consequently supply of service.

The outright purchase of software by an end user constitutes supply of something different from the supply of the right itself to use. It is the supply of goods. The matter in detail has been discussed. It will also be discussed later.

Permanent establishment - Provision of services by the Business Process

11.21-6 Outsourcing Taxation of Business Process Outsourcing Units (BPO units) of the non-residents or foreign companies in India has been a subject-matter of debate. The Central Board of Direct Taxes of India has now clarified in their Circular No. 1/2004, dated 2-1-2004 (2004) 134 Taxman 45 (Statutes). The Board clarified :

- In case where a non-resident, carrying on manufacture and sale of goods or merchandise or provision of services outside India, outsources of some of its incidental activities, viz., conclusion of contracts and procurements of orders (which enable the core activities to be carried abroad) to an IT-enabled entity in India, which constitutes a permanent establishment of the non-resident principal, then the insignificant profit which is difficult to determine and attributable to the conclusion of such contracts or procurement of such orders can be considered to be embedded in the income of the permanent establishment taxable in India, if the price charged in respect of the above services by the permanent establishment is an arm's length/fair market price. In such a situation, therefore, no income shall separately accrue or arise or deemed to accrue or arise to non-resident principal in India;
- An example of such services by an IT-enabled entity in India could be
 - a case where a foreign company manufacturing computers abroad and also selling such computers to customers abroad, engages or sets up a call centre in India to procure orders from or conclude contracts with customers abroad and also answer sales related queries on telephone. In such a case, no income shall accrue or arise to the non-resident in India, apart from the income of the call centre;
 - similarly, where a foreign insurance company insuring risks in countries other than India appoints or sets up a call centre in India to attend to calls from customers outside India regarding acquisition of new insurance policy or revision of existing policy, to disseminate relevant information and accepts insurance proposals from the customers, while actual policy insurance as well as collection of premium is done outside India by the foreign insurance company, no profits on the non-resident shall be taxable in India, apart from the income of the call centre if the charges paid to the call centre for its services are at arm's length/fair market price.
 - a case of credit card company issuing credit cards to customers living in countries other than India, appointing or setting up a call centre in India to attend to calls from customers outside India seeking to acquire a new credit card. That centre only disseminates relevant information and accepts the request for issue of a credit card from the customer while the actual card issuance, the delivery of the card and collection of charges are being done outside India by the foreign credit card company and the charges paid to the Indian call centre for its services are at arm's length/fair market price.
- On the other hand, where a non-resident or a foreign company outsources the whole or part of its core revenue generating business activities to an IT-enabled entity in India, such as the services of a travel agent, software developer, software maintenance, investment consultant, debt collection services, etc., and the IT-enabled activity in India renders the services either directly to the customers abroad or through the non-resident principal, a considerable portion of the profits derived by the non-resident or the foreign company from its customers abroad would certainly be attributable to the activities performed by the IT-enabled entity in India. If such entity constitutes a permanent establishment of the non-resident or foreign company in India, such attributed profits would be taxable under the Income-tax Act, 1961, in accordance with the provisions of the relevant tax treaty. The circular has since been withdrawn. The principles set out therein are state applicable circular or no circular.

Permanent establishment - Furnishing of services - Turnkey project

11.21-7 A question arises whether any consideration received by a company for providing technology or technical know-how in the course of a turnkey project could be taken as royalty income or as for providing services. A contract for a turnkey project is taken as a whole and is not normally split up into many segments as if there are separate agreements, say, for example, supply of providing technical know-how or technology, goods etc. used in the course of carrying the project. Turnkey contracts combine the provision of tangible assets, such as machinery, with technical services, training and communication of knowledge forming the technical know-how or technical assistance provided up to the completion of the work, as well as securing resources to acquire all types of property outside the country. The price paid to the supplier is the total contract price which covers all stages involved from the beginning till the commission of the project. The contract is for the delivery of the final product and the price is paid for it, though in the course of its production the contractor may use his skill, technical know-how, expertise, or

other property. The consideration received is not for the use of the technical know-how or skill or technical services, but from the activity of providing a turnkey project. If a customer engages the vendor to create an item of property that the customer will own from the moment of its creation, then no property will have been transferred from the vendor to the customer. The transaction is the transaction of service, irrespective of the vendor having made use of his property and transferred it in the process. The predominant nature of the transaction is not the transfer of the property itself but the provision of services. Mere passing the property in an article or commodity during the performance of the transaction of rendition of service does not render the transaction to be a transaction of sale. Even in a contract purely of service, it is possible that articles have to be used by the person rendering the service and the property may pass to the other party. That would not convert the contract into one of sale of these materials. Where the consideration is composite and covers not only price of the goods but also the costs of other operations to be performed by or through a business connection in a country, in regard to the sale of goods, the profit accruing or arising therefrom would be deemed to accrue or arise in that country.

[See *Ishikawajima-Harima Heavy Industries Co. Ltd., In re* [2004] 271 ITR 193 (AAR - New Delhi). The Madras High Court in *CIT v. Neyveli Lignite Corporation Ltd.* [2000] [243 ITR 459](#) (Mad.) observed:

"In a contract for the design, manufacture, supply, erection and commissioning of machinery which does not involve licence of the patent concerning the machinery, or copyright of its design, mere supply of drawings before the manufacture is commenced to ensure that the buyer's requirements are fully taken care of and the supply of the diagram and other details to enable the buyer to operate the machines, and also to assure the buyer, that the machines will perform to the specification required by the buyer, such supply is only incidental to the performances of the total contract which includes design, manufacture and supply of the machinery.

The price paid by the assessee to the supplier is a total contract price which covers all the stages involved in the supply of machinery from the stage of design to the stage of commissioning."

But the Supreme Court of India in *Ishikawajima- Harima Heavy Industries Co. Ltd v. DIT* [2007] [158 Taxman 259](#) [reversing the ruling of the Authority for Advance Ruling *Ishikawajima- Harima Heavy Industries Co. Ltd., In re* [2004] 271 ITR 193 (AAR)] held that the contract may be fashioned as a turnkey contract by itself may not be of much significance. The project may be turnkey project. The contract may also be a turnkey contract, but the same by itself would not mean that even for the purpose of taxability the entire contract must be considered to be an integrated one so as to make the appellant to pay tax in India. The taxable events in the execution of a contract may arise at several stages in several years. The liability of the parties may also arise at several stages. Obligations under a contract are distinct ones. Supply obligation is distinct and separate from service obligation. Price for each of the component of the contract is separate. Similarly, offshore supply and offshore services have been separately been dealt with. Prices in each of the segment are also different. The Supreme Court in view of these facts held that the contract where different parts of the composite contract are performed at different places, the principle of apportionment can be applied, to determine which fiscal jurisdiction can tax that particular part of the transaction. The said principle helps to determine where the territorial jurisdiction of a particular State lies, and its capacity to tax an event. Applying it to composite transactions which have some operations in one territory and some in others, is essential to determine the taxability of various operations.

Permanent establishment - Composite contract for designing, supplying and erecting machinery

11.21.8 Where, the total contract price which covered all stages involved in the supply of machinery, the contract is not split up. This was held by the Delhi High Court in *CIT v. Mitsui Engg. & Ship Building Co. Ltd.* [2003] [259 ITR 248](#) . In that case, contract for designing, engineering, manufacturing, shop testing and packing f.o.b. port of embarkation could not be split up since the entire contract was to be read together and was for one complete transaction. It was in the said fact situation held that it was not possible to apportion the consideration for design on one part and the other activities on the other part.

The Madras High Court in *CIT v. Neyveli Lignite Corporation Ltd.* [2000] [243 ITR 459](#) (Mad.) observed:

"In a contract for the design, manufacture, supply, erection and commissioning of machinery which does not involve licence of the patent concerning the machinery, or copyright of its design, mere supply of drawings before the manufacture is commenced to ensure that the buyer's requirements are fully taken care of and the supply of the diagram and other details to enable the buyer to operate the machines, and also to assure the

buyer, that the machines will perform to the specification required by the buyer, such supply is only incidental to the performances of the total contract which includes design, manufacture and supply of the machinery.

The price paid by the assessee to the supplier is a total contract price which covers all the stages involved in the supply of machinery from the stage of design to the stage of commissioning. The design supplied is not to enable the assessee to commence the manufacture of the machinery itself with the aid of such design. The limited purpose of the design and drawings is only to secure the consent of the assessee for the manner in which the machine is to be designed and manufactured, as it was meant to meet the special design requirements of the buyer."

Thus, if there is mere use of, and no sale or transfer of any right in, the technical know-how or the technology during the course of carrying out the project, the consideration received would be of the nature of business income. If sale, it would be of the nature of capital gains.

In *ITO v. Sriram Bearings* [1997] [224 ITR 724](#) (SC), the respondent company entered into a technical collaboration agreement with a non-resident Japanese company. The assessee proposed to manufacture cylindrical, spherical and tapered roller bearings in India. The said agreement was in two parts - one is to sell trade secrets (know-how - by the Japanese company relating to the products and manufacturing technique which also included the patent rights and advice of plant layout and installation. The consideration for this part of the agreement was US dollars 1,65,000, free of Indian income-tax and payable in Japan. The second part related to rendering of technical assistance and training of personnel by the Japanese company. The question for consideration was whether the income of US dollars payable by the Indian company to the Japanese company could be said to have accrued to the Japanese company in India. The Calcutta High Court held that the amount did not accrue in India. On appeal, the Supreme Court affirmed and held that there was no basis to say that any part of the sum of 1,65,000 US dollars had been earned in India.

Permanent establishment - Activities of preparatory and auxiliary nature

Activities which are not taken permanent establishment

11.22-1 Paragraph 4 of article 5 contains exception to the general definition as laid down in paragraph 1 and not to include the following to mean permanent establishment, which is designed to prevent an enterprise of one State from being taxed in the other state, if it carries on in the other State activities of purely preparatory or auxiliary nature.

- ...■ The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise. [See sub-paragraph (a)]
- ...■ The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display. [See sub-paragraph (b)]
- ...■ The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise. [See sub-paragraph (c)]
- ...■ The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise. [See sub-paragraph (d)]
- ...■ The maintenance of the fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. [See sub-paragraph (e)]

The UN Model uses the expression "storage or display" whereas the OECD Model Convention uses "storage, display or delivery". The word "delivery" is missing in the UN Model, which means that under that Convention maintenance of goods for delivery is deemed not to be preparatory or auxiliary but a core business activity.

Under sub-paragraph (a) some fixed facility must be available for use by the enterprise such as a warehouse or open space, but no such facility is required under subparagraph (b) for maintenance of stock of goods or merchandise. Thus, sub-paragraph (a) relates to the case in which an enterprise acquires the use of facilities for storing or displaying (or delivery, OECD Model) its own goods or merchandise and sub-paragraph (b) to the stock of goods or merchandise itself and provides that the stock, as such, shall not be treated as permanent establishment if it is maintained for the purpose of storage, display (or delivery). Sub-paragraph (c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed itself by a second enterprise, on behalf of,

or for the account of, the first-mentioned enterprise. The reference to the collection of information in sub-paragraph (d) is intended to include the case of newspaper bureau which has no purpose other than to act as one of many 'tentacles' of the parent body; to exempt such bureau is to do no more than to extend the concept of "mere purpose" (see OECD Commentary, article 5, para 22). Subparagraph (e) is a generalized exception to the general definition in paragraph 1 and when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment (see paragraph 23 of the OECD Commentary).

Preparatory auxiliary activities - Features

11.22-2 The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in sub-paragraph (e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1 (see OECD Commentary, article 5, paragraph 21). The duration of the activity is of no importance till they remain preparatory or auxiliary. The activity of keeping goods or merchandise for storage, display, processing by another enterprise, or of purchasing goods or merchandise and collecting information should be restricted purely for the said purpose, as the use of word "solely" suggests. If goes beyond, it falls outside the exception, for example,

- ...■ a fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level (OECD Commentary, paragraph 24),
- ...■ a fixed place of business which is maintained for the delivery of spare parts to customers of machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as the after-sale organization performing an essential and significant part of the services of an enterprise *vis-a-vis* its customers (OECD Commentary, article 5, paragraph 25),
- ...■ a fixed place of business which does not only give information but also furnishes plans etc., specially developed for the purpose of an individual customer (OECD Commentary, paragraph 25),
- ...■ a fixed place of business which is research establishment concerns itself with manufacture (OECD Commentary, paragraph 25),
- ...■ a fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owing the fixed place belongs (OECD Commentary, article 5, paragraph 26),
- ...■ a fixed place of business which is an advertising agency is also engaged in advertising for other enterprises (OECD Commentary, article 5, paragraph 28),
- ...■ a fixed place of business where a store is maintained for delivery of goods is also engaged in sales (OECD Commentary, article 5, paragraph 30)

All activities mentioned in paragraph 4 lose their preparatory or auxiliary character if they serve the core business activity, with the exception of the activity of purchasing. That activity would not be taxable, even if other business activities are also carried on through that place (see OECD Commentary, article 7, paragraph 30)

The fixed place of business, which would otherwise constitute permanent establishment, used for storage or display of goods belonging to a resident of the other Contracting State and the maintenance of an inventory for similar purpose, or used solely for the purpose of purchasing of goods or solely for the processing of goods by other enterprise, or used for collection of information or to the performance of other such activities of preparatory or auxiliary nature on behalf of the enterprise of which it is the place of business, is not deemed to be a permanent establishment. If a representative office restricts its activities as mentioned above, or to making contracts, gathering or transmitting information to its head office, disseminating information about the products and services of the foreign enterprise and receiving enquiries about those products and services, such an office cannot have an extended meaning of 'permanent establishment', provided such activities do not go beyond their support functions and yield profits, in the sense that the profits could be said to have been derived from such activities.

The common feature of all the activities listed under this paragraph is that these are of preparatory or auxiliary to the carrying on of the business by the enterprise, though the words 'preparatory or auxiliary character' are found only in sub-paragraph (e) which reads as follows:

"The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character."

The question is whether the words "any other" "before" "activity" refer to activities which are in addition to, or to also all those mentioned in the preceding sub-paragraphs. In fact sub-paragraph (e) is an extension of the preceding, as could be discerned from the nature of activities mentioned in them.

The purpose of these being of storage or display of goods or merchandise, or for collection of information, etc., are preparatory and auxiliary in character. Sub-paragraph (e) provides a generalised exception to the definition in paragraphs 2 and 3, which read with those paragraphs provides a list by which to determine negatively, what does not constitute permanent establishment. Such a test makes it unnecessary to chalk out an exhaustive list of exceptions to the definition of permanent establishment in paragraphs 2 and 3.

The word 'other' is not a word of limitation but of extension, so as to cover all possible ways in which the activity of auxiliary or preparatory character could be undertaken by an enterprise or person without the latter being designated as permanent establishment. It is included to cover also the cases which may not come within the expressed meaning of the preceding sub-paragraphs, though their purpose and character are similar. The words 'any other' mean analogous to those specified before—*Moran Mar Basselios Catholicos v. Most Rev. Mar Poulouse Athanasius* AIR 1954 SC 526 and *Benoy Krishna Rohatgi v. Surajbali Misra* AIR 1963 Cal. 100. Thus all the activities specified in the preceding sub-paragraphs are similar and analogous, viz. preparatory or auxiliary.

The activities which are preparatory or auxiliary in nature are those which relate to providing services to the head office (see OECD Commentary, article 5, paragraph 26). Back office operations to support front office functions are preparatory or auxiliary in Charter [see *DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) (SC)]. Some of the auxiliary activities besides those specified in article 4 are advertising, supplying information, scientific research, servicing of patent or a know-how (see OECD Commentary, article 5, paragraph 23); also see *Morgan Stanley* case ([292 ITR 416](#))

AdvertisingAdvertising

11.22-3 To advertise means to draw attention of the public to the product manufactured or services provided by an enterprise, in order to increase sale. Providing general product information to the public is not the general purpose of an enterprise. General purpose is to accumulate capital through manufacturing of goods, production of services and marketing them. Advertising helps increasing but does not effect sales. Knowledge may lead the public to having general information about the product but cannot make it to make purchases, though may ultimately be induced to do so. The activity may well ultimately contribute to the productivity of the enterprise, but that contribution at the moment does not realize income or increase the value of assets and therefore, so remote that allocation of profit to the activity of advertising becomes difficult.

A company which is primarily concerned with marketing its products and exports to other country on FOB basis as a result of orders solicited solely by advertising from its own country is obviously trading with another country. The advertising office, therefore, is not a PE. It would, however, be, if advertising is the business and thus the general purpose of the enterprise. The activity in that case is not remote enough as not to attribute profits to it. Similarly, the activity of the office soliciting orders is not remote, even without its employees having no authority to conclude contracts.

Supplying informationSupplying information

11.22-4 Collecting or supplying information for the head office is a preparatory or auxiliary activity, if such an activity is not the primary purpose of the enterprise. Philip Baker in his book *Double Taxation Convention* (2003 edition) illustrated by a decision of the High Court of Fiji, thus, "an office maintained in Fiji by the Commonwealth Development Corporation, which existed to gather information, check on the progress of project, and identify possible investment opportunities (the decision to invest being taken in London) was held not to constitute a permanent establishment [*Commonwealth Corporation v. CIR* October 28, 1992, (No. 1 of 1991) (High Court of Fiji)]. In a US administrative ruling (IRS in Rev. Rul. 72-418. 1972-2 C.B. 661) an office in the US of the German bank obtained information for the head office regarding commercial and financial matters in the US. It also supplied information to the financial institutions, customers etc., about the German matters. The office was not engaged in any of the bank's main activities. The IRS concluded that there was no PE because the activities conducted by the office was auxiliary to the main purpose of the bank.

Philip Baker quoted a Swiss case where a Spanish bank kept an office in Switzerland for the purpose, *inter alia*, of obtaining information for the head office. The office was held not to be PE. In another US case (IRS in Ltr. Rul. 81, 47-171) a similar conclusion was reached with respect to the activity of obtaining market information for a foreign technology enterprise.

The Supreme Court in *DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) held that the Indian Company was engaged in supporting the main office functions of the US Company in equity and fixed income research, account reconciliation and providing IT enabled services such as back office operation, date processing and Support Centre, and that it does not constitute PE as it is performing in India only back office operations.

Scientific researchScientific research

11.22-5 Scientific research and development is considered preparatory activity and non-PE- constituting, though in the long run it may well contribute to the productivity of the enterprise. Till then, it is difficult to allocate any profit. It is auxiliary if the service is provided to the head office but not, if done to others as was held by the French Conseil d'Etat [July 6, 1983, (1983) R. J. F. 526]. In that case, Paris office of a Swiss research centre sought out French clients for research work and signed contracts with them in the name of the centre. The centre performed research for a consideration. Such an act is not preparatory or auxiliary activity. Research activity within a group of related companies would constitute a PE (*see* OECD Commentary, article 5, paragraph 28)

Servicing of patent or know-howServicing of patent or know-how

11.22-6 Servicing of patent or a know-how is an auxiliary activity if such an activity is not the core business and if the sole activity (*see* OECD Commentary, article 5, paragraph 23). Protecting patents against infringement is an auxiliary activity (*see* IRS in Rev. Rul. 80-15 1980-1 C.B. 365). A PE would, however, be constituted if the main purpose of the enterprise is to handle patents (RFH in RStB1 1939)

Preparatory and auxiliary activity lacking value additionPreparatory and auxiliary activity lacking value addition

11.22-7 Preparatory and auxiliary activities have been defined in para 23 of OECD Commentary on article 5 as the services which the place of business "performs are so remote from the actual realisation of profits that it is difficult to allocate to any profit to the fixed place of business in question." This is so even when such services may contribute to the productivity, though normally, a fixed place of business must have a productive character, *i.e.*, contributing to business earnings, *i.e.*, manufacturing or sale. Mere presence of establishment is not enough; it must contribute to the business earning. Article 5(1) postulates first the existence of fixed place and secondly business is carried on through such place. Performing back office functions does not satisfy the second part of article 5(1) [*see DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) (SC)]. If establishment does not contribute to business earning, it would not be a permanent establishment such as information bureau, storehouses, purchasing offices, advertising displays and showrooms where no goods are sold.

A company which is primarily concerned with the marketing its products and exports to other country on FOB basis as a result of orders solicited solely by advertising from its own country is obviously trading with another country. For the purpose of advertising or soliciting orders, it may maintain stock of goods or merchandise for storage or display. Similarly, for the purpose of purchase, it may have place for collecting information. Storage or display or purchase for such purpose do not contribute to the earning of the foreign company. These are only ancillary to profit making activity of the enterprise.

Preparatory and auxiliary activities - Factors for determinationPreparatory and auxiliary activities - Factors for determination

11.22-8 Whether any of the exception clause of paragraph 4 applies, the general purpose and nature of the activity and its relative importance is to be examined. It is to be seen -

- (1) whether there is identity between the general purpose of the enterprise as a whole and the general purpose of the fixed place of business, *i.e.*, whether the nature of the activity of the fixed place of business is essential to the business of the enterprise ;
- (2) whether the activity is relatively important

It may be mentioned that the activities of the fixed place must be carried on for the enterprise. It would be regarded as PE if

- ...■ it renders services not only to the enterprise but also directly to other enterprises for example to other companies of a group to which the company owing the fixed place (*see* OECD Commentary, article 5, paragraph 26),
- ...■ exercises any of said preparatory or auxiliary functions not only on behalf of the enterprise but also on behalf of other enterprises as for example an advertising agency maintained by the enterprise engaging in advertising for other enterprises (*see* OECD Commentary, article 5, paragraph 28),
- ...■ is used both for such preparatory or auxiliary activities and also for other activities as for example, where a store maintained for the delivery of goods also engaged in sales (*see* OECD Commentary, article 5, paragraph 30).

Thus any of the activities mentioned in the excepted list will be a PE activity if it serves the core business activity performed through the same place of business. For example, use of facilities not only for display and delivery but also for solicitation of orders and thus pursuing sales activities (*see* IRS in Rev. Rul. 62-31 1962-1). A UK corporation opened a sales office or showroom in the US, where UK merchandise were displayed. The personnel at the office were not authorized to conclude sales contracts and also did not have stock from which to fill orders (there was thus no agent PE), but their authority was limited to running the office, soliciting orders and arranging appointment of distributing agents of the UK Corporation. The UK corporation controlled the fixed place of business and pursued a core business activity, *i.e.*, sales activities, through it.

General purpose of the activities of the enterprise and of the fixed place of business

11.22-8A The first aspect relates to distinction between the core business activity of the enterprise as a whole and the activity undertaken by the fixed place of business. What distinguishes is that core business activity contributes to the business earning or has the effect of adding value, which activity "in itself forms an essential and significant part of the enterprise as a whole" (*see* OECD Commentary article 5, para 24). What is essential and significant is difficult to comprehend, as according to the enterprise every activity is essential and significant otherwise it would not have pursued it. Adding value to the going concern by way of increasing income or the asset value, is the criterion.

The majority of the activities mentioned in paragraph 4 are auxiliary which may be preparatory in the circumstances of a particular case. Arvid A. Skaar in his book *Permanent Establishment* observed : "The majority of the excluded activities are auxiliary. Depending on the circumstances, however, they may also be preparatory. Market surveys and the collection of other information about a foreign country may be the first step towards a more substantial engagement there. The maintenance of goods or merchandise may also be introductory step towards more extensive commercial operations. Normally, preparatory activities will lead to a core business activity within a short period of time. A PE will be constituted from the first day on this basis". The learned author illustrated the preparatory nature of the activity by quoting the decision of the US Tax Court in *Consolidated Premium Iron Ores Limited v. Comm'r* 28 TC 127 [1957], where a Canadian enterprise had agents in the US with very limited power of attorney to obtain commitments from steel companies to buy iron ores from it. The company had also procured licence from the State Ohio and printed a letterhead with the same address as one of the stockholders. It did not, however, form an organization in the US and no business was done under the licence, which was ultimately surrendered. The court held that there was no PE. The learned author observed "The rationale of the Court's denial of a PE is that these activities were preparatory, and did not meet the tax treaty's requirement of a 'business activity'"

The place of business does not exercise preparatory or auxiliary activity if its general purpose is one which is identical to the general purpose of the whole enterprise (*see* OECD Commentary, article 5, para 24). General purpose of an enterprise is to accumulate capital through manufacturing of goods, production of services and marketing of goods and services Sales activities increase income, and manufacturing, asset value. If an enterprise carries on manufacture and sale, it is not possible to say that the place where the profits accrue to it is the place of sale. Profits attributable to manufacturing business are said to arise at a place where manufacturing is being done and the profits which arise by reason of the sale are said to arise where sales are made [*see CIT v. Ahmedbhai Umarbhai & Co.* [1950] SCR 335 (SC), Mahjan J.]. Even in the business of manufacturing, it is the act of sale through sales outlet profits arise. Thus, the act of sale is the mode of realizing the profits of both manufacturing and trading business. Sales outlet is the PE of a manufacturing enterprise. It may be a fixed place of business or an

agent. The activities which are associated with sales are the (1) pre-sale activities, (2) conclusion of sale contract, and (3) post-sale activities. Activities of the second type are rarely preparatory or auxiliary; of the first mostly and of the third occasionally.

Pre-sale auxiliary activities

11.22-9 Pre-sale activities for promotion of sale such as advertising, display, or warehousing of goods or merchandise or collecting information are not PE-constituting business activities, if these are the only activities which are performed through the fixed place of business. They are so remote from the actual realisation of profits that it is difficult to allocate any profit to that place of business. Remoteness absent, PE is constituted. A place of business is PE if engages in negotiating contracts, even if finalized by somebody abroad, PE is constituted (*see* IRS in Rev. Rul. 62-31 1962-1 C.B. 367). The OECD Commentary, article 5, para 23 stated "Examples are fixed places of business solely for the purpose of advertising or for supply of information or for scientific research or for the servicing of patents or a know-how contract", if these do not form the core business of the enterprise. If the activity say for example advertising is the business of the enterprise, then the advertising is not an auxiliary activity. Similarly, if the primary purpose is collection of information, then collecting information is not an auxiliary activity. The German Supreme Court in a decision (BFH in BStB1 1985 II 417) held that collecting, processing, translating and commenting upon information went beyond a preparatory or auxiliary level, as editing and dissemination of news was an essential part of a newspaper's business. Thus collecting information would be preparatory or auxiliary activity, if the fixed place of business is not engaged in an editorial function in the newspaper organization. This conclusion must be considered a correct interpretation of the OECD based PE exception for a newspapers collection of information in another country."

An office of a Bank set up for the purpose of collecting and furnishing information is not a PE, if it is not engaged in any banking activities such as buying, selling, paying or collecting bills of exchange, issuing letters of credit or receiving money for transmission or transmitting money on draft, check, cable or any other way etc.

The OECD Commentary (paragraph 24) illustrated the concept of identity of general purpose by examples as follows:

"Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of sub-paragraph (e). A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such managerial activity exceeds this level. If enterprises with international ramifications establish a so called 'management office' in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called poly-centric enterprises) the regional management offices even have to be regarded as a 'place of management' within the sub-paragraph (a) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of sub-paragraph (e) of paragraph 4".

Post-sale auxiliary activities

11.22-10 Post-sale activities include mainly providing services and spare parts. If part of contract of sale, these are incidental to sale, but not if covered separately and paid separately.

Preparatory and auxiliary activity constitutes PE, if significant part of the activity

11.22-11 Maintenance of fixed place of business solely for the purpose of carrying on, for the enterprise, any activity of a preparatory or auxiliary character shall not make such fixed place as PE. "Carrying on the business" by the enterprise and not any other activity of preparatory or auxiliary nature for it, is the requirement for the fixed place to be taken as PE of that enterprise. If the activity is limited to a preparatory or auxiliary one, the fixed place

is not taken PE. This would not be the case, where, for example, the fixed place does not only give information but also furnishes plans etc. specially developed for the purpose of the individual customer; nor would it be the case if research establishment were to concern itself with manufacture (*see* paragraph 25 of the OECD Commentary on Article 5). Similarly, if a fixed place of business which renders services not only to its enterprise but also directly to other enterprises, it cannot be said to be carrying preparatory or auxiliary activities for the enterprise (*see* paragraph 26 of the OECD Commentary).

If the sole purpose of its maintenance is to carry on such activities as are preparatory or supplementary or subsidiary to, but not themselves represent, business, the fixed place will not qualify as PE. If the activity in itself forms an essential or significant part of the activity of the enterprise, that activity cannot be said to be preparatory or auxiliary in nature. Its nature is business, and not preparatory or auxiliary. The criterion appears to be this; whether the activity itself is the business activity; if yes, it cannot be preparatory or auxiliary. The words "preparatory" and "auxiliary" indicate that some other thing must exist or contemplated for whose support or help such activities are directed. The OECD Commentary on Article 5 gives the following illustrations :

- where the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot be said exercising activity of preparatory or auxiliary in nature (*see* paragraph 24);
- if enterprises with international ramifications establish a so-called "management office" in States in which they maintain subsidiaries, permanent establishments, agents and licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, a PE will normally be deemed to exist, because the management office itself is so deemed (*see* paragraph 24);
- the function of managing an enterprise, even if only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore, can in no way be regarded as an activity which has a preparatory or auxiliary character (*see* paragraph 24);
- the activities of after-sale organisations which perform an essential and significant part of the services of an enterprise *vis-a-vis* its customers are not merely auxiliary (*see* paragraph 25).

Permanent establishment- Preparatory and auxiliary activity- relative importancePermanent establishment- Preparatory and auxiliary activity- relative importance

11.22-12 Each individual case is examined on its merits, to ascertain the nature and importance of the business activities carried through the place of business, relative to the activities of the enterprise as a whole. Relatively of insignificant nature are auxiliary and preparatory and the place of business is not the PE Activities which are excepted are those which are purely preparatory auxiliary in nature (*see* para 21 of the OECD Commentary, article 5), *i.e.*, those which are purely auxiliary in nature from commercial point of view; commercially insignificant in the context of total activity of the enterprise, in terms of its turnover, value of the stock, number of employees etc. A fixed place of business maintained for the delivery of spare parts to customers for machinery supplied to those customers may be preparatory or auxiliary activity, but its activity of maintaining or repairing such machinery which is essential and significant part of the services of an enterprise *vis-a-vis* customers, is not such an activity 1 (*see* paragraph 25 of the OECD Commentary, article 5).

Permanent establishment- Preparatory or auxiliary activities - CombinationPermanent establishment- Preparatory or auxiliary activities - Combination

11.22-13 The excluded categories of business activities are only five, as set out in clauses (a) to (e) of paragraph 4. Clause (f) provides that fixed place of business maintained solely for any combination of activities mentioned in sub-paragraphs (a) to (e) would not be taken a PE, provided that overall the activity of the fixed place as resulting from the combination is of preparatory or auxiliary character. The purpose of the clause is explained in the OECD Commentary, article 5, para 27 as follows:

"Therefore, according to sub-paragraph (f) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in sub-paragraphs (a) to (e) of paragraph 4 does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The

criterion 'preparatory or auxiliary character' is to be seen in the same way as is set out for the same criterion of sub-paragraph (e) (cf. paragraphs 24 and 25 above)"

The criterion is that a fixed place of business does not exercise a preparatory or auxiliary activity if its general purpose is identical to the general purpose of the whole enterprise. A combination of activities which are each preparatory or auxiliary may not always result in overall activity which is also preparatory or auxiliary. Preparatory or auxiliary nature of each activity does not lead to an automatic conclusion that a combination of them will also have the same nature, as we cannot say that 2 and 2 always be 4 but it could be 22. The effect of whole may not be the same as of the sum total of the constituents. Each activity individually be insignificant or inessential but collectively significant or essential so that there is identity between the general purpose of the combination and of the enterprise. The commercial significance of the combination decides whether such combination be taken as PE.

In a case before the German Supreme Court (BFH in BStB1 II 560) a US bank rented office space hired staff and transferred capital in order to open a branch in Germany and made an application which was approved and the branch was registered. Each activity was preparatory in nature, but their combination, in the opinion of the Court, transcended preparatory level and constituted a PE in Germany.

Auxiliary activities combining themselves or with some core business activities conducted through the fixed place of business or through independent agents, may constitute PE if such combination has commercial significance to the enterprise and becomes taxable as a single PE. The only exception being the activity of purchasing which would not lose its auxiliary nature as a permanent establishment; carrying on purchasing for its head office, along with other business activities, cannot be taxed to profit attributed to the activity of purchase (*see* paragraph 30 of the OECD Commentary, article 7). A fixed place of business would be regarded as a single PE and taxable as regards both types of activities, for instance, where a store maintained for delivery of goods and also engaged in sales (*see* OECD Commentary, article 5, paragraph 30). Hoge Raad in BNB (1976/121) (Street Market case) considered a case and decided that the auxiliary activities in combination with other business activity constituted a PE. Two residents of the Netherlands bought flowers and transported them to a shed (warehouse) in Germany, for storage and repacking and thereafter selling in the street markets. They lent a room and kept records there. The storage, repacking, and book-keeping were auxiliary activities conducted through fixed place of business while the sales activities through a street not a fixed place. The Netherlands Supreme Court found that the warehouse constituted a PE, though auxiliary activities were done there.

There may be a case where an enterprise has many fixed places of business in a country, each engaged in an activity of preparatory or auxiliary nature. For deciding whether a PE exists, it is first to be seen whether they are separated from each other locally or organizationally and if it is so, then viewed separately and in isolation and not in combination as provided in sub-paragraph (f). (OECD Commentary, article 5, paragraph 27.1). Places are locally separated if they are located in different areas and organizationally separated if managed by different departments of the enterprise and performing functions which are not complementary. Places of business are not organizationally separated, as per OECD Commentary, article 5, paragraph 27.1, where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another. According to the Commentary an enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. Places are not locally or organizationally separated if their collective operation are the cohesive business operations.

Indo-Norwegian treaty provides :

"...the provisions of sub-paragraphs (a) to (e) shall not be applicable where the enterprise maintains any other fixed place of business in the other Contracting State for any purposes other than the purposes specified in said subparagraphs".

The provision is similar to the force of attraction rule in paragraph 1 of article 7 of the UN Model Convention. It does not refer to the combined effect of the preparatory or auxiliary activities as specified in sub-paragraphs (a) to (e). It only provides that if a place of business is maintained for any other than, besides other places maintained for, the activity of the preparatory or auxiliary in nature, the other places lose the exception protection. Thus, if any place in a country is engaged in a core business activity, then the preparatory or auxiliary activities of other places are not excepted and the core business and the excepted combined together to constitute a PE. This proposition would have been available otherwise than the said specific provision in the Indo-Norwegian treaty.

Arvid A. Skaar concluded in his book "Permanent Establishment"

"The conclusion is that any of the activities in the 'negative list', except purchasing of goods, will be a PE activity if they serve a core business activity performed through the same place of business. This conclusion applies even if the auxiliary activity serves the head office only. This includes a combination involving manufacturing, management, and sales, *inter alia* conclusion of contracts, as well as the soliciting of orders through the place of business."

Permanent establishment - Preparatory or auxiliary activities - Employees are not agents

11.22-14 A place of business is not deemed to constitute a PE if its activities are restricted to the excepted functions, even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of that place. Such employees when authorized to conclude such agreements are not considered agents within the meaning of paragraph 5 of article 5. For example, a research institution does not become a PE if its manager having been authorized, concludes contracts necessary for its maintaining (*see* OECD Commentary, article 5, paragraph 28). The Commentary further clarifies that the place of business would be taken a PE if while exercising any of the excepted functions it were to exercise them not only on behalf of the enterprise but also on behalf of other enterprises; for example, an advertising agency maintained by an enterprise is also engaged in advertising for other enterprises.

Permanent establishment - Preparatory or auxiliary - Disposal of merchandise displayed at fair

11.22-15 If a fixed place of business is deemed not to be a PE in terms of paragraph 4 of article 5 by reason of its activities being of the preparatory or auxiliary nature, it would not be taken to be one on its movable property having been sold on the termination of the said activities. For example, sale of the merchandise of an enterprise displayed at the termination of a trade-fair would not constitute a PE. (*See* OECD Commentary, article 5, paragraph 29). The exception applies to sale of the merchandise displayed and not to those not displayed.

Permanent establishment - Preparatory or auxiliary - Storage, display or delivery of goods

11.22-16 Storage, display or delivery is a preparatory or auxiliary activity if the facility is used or the stock of goods or merchandise maintained, solely for that purpose subparagraph (a) of paragraph 4 of the OECD Model Convention refers to the use of the facilities by an enterprise for its own goods or merchandise and sub-paragraph (b) maintenance of stock and thus providing that the stock as such shall not be treated as PE (*see* OECD Commentary, article 5, paragraph 22). The facility which is solely used for storage would not constitute a PE, even if "warehouse" has been specifically mentioned in paragraph 2 to be a PE. But if others are let use the facility of the warehouse for storage, it would be a PE because in that case letting of the storage space to the third parties is the business activity of the enterprise. Casual and temporary use of merely storage facilities by the third parties, would not constitute a PE because such a casual and temporary use does not reach the level of a business activity. The OECD Commentary, article 5, paragraph 4 states that a place of business may be constituted by a certain permanently used area in a customs depot (*e.g.*, for the storage of dutiable goods). Having so said, the Commentary does not say that the place of business constitutes a PE. That fixed place of activity may be exempt if it is used solely for storage and storage is the only activity display of goods at a place is not a PE constituting activity, unless goods are sold or solicited from that place. The sale at the termination of a trade fair or convention, however, would not constitute a PE (*see* OECD Commentary, article 5, paragraph 29). According to US practice, a storehouse generally used for display of goods or merchandise with only occasional and minor deliveries does not constitute a PE (*see* IRS in Rev. Rul. 56-594, 1956 -2 C.B. 1126)

Delivery of goods or merchandise by itself would not constitute a PE unless the place is also engaged in sales (*see* OECD Commentary, article 5, paragraph 30). If all sales are effected outside a country and goods delivered from a warehouse maintained in that country for that purpose, no PE is constituted. Arvid A. Skaar illustrated by an example, in his book "Permanent Establishment"—

"For example, it may be the case that an oil company utilized a fixed place of business for deliveries of oil to wholesale dealers in a country. All refining and sales activities are done by the head office in another country. The facilities are run by oil-company employees with no authority to conclude sales contracts. The employees

are responsible only for the reception of oil and delivery of it to wholesale dealers according to instructions from the head office. However, the value of the deliveries to the country is substantial (from the oil company's point of view). Clearly, this is delivery of stocks."

Storage, facilities for display and delivery as well as solicitation of orders would constitute a PE (*see* US administrative practice, IRS in Rev. Rul. 65-263 1956-2 C.B. 561).

Permanent establishment - Preparatory and auxiliary - Storing for processing

11.22-17 Storing goods or merchandise solely for the purpose of processing by a third party is not a PE constituting business activity. In common parlance processing is understood as an action which brings forth some change or alteration of the goods or material subjected to the act of processing [*see Delhi Cold Storage (P.) Ltd. v. CIT* [1991] [191 ITR 656](#) (SC)]. It is subjection of goods to some special process of development, for a preparation for the market or of conversion into marketable form such as livestock by slaughtering, grain by milling, cotton by spinning, milk by pasteurizing and fruits and vegetables by sorting and repacking [*Addl. CIT v. Kasli Tyres (P.) Ltd.* [1981] [131 ITR 636](#) (Delhi)]. Processing is thus an operation on an article so that it undergoes a change [*CIT v. Sterling Foods (Goa)* [1995] [213 ITR 851](#) (Bom.)]. The purpose of storing is the processing by the third party and not the enterprise. The activity does not lose its preparatory or auxiliary nature if some insignificant and minor activity is done by the enterprise on behalf of the buyer, such as packaging.

Permanent establishment - Preparatory or auxiliary - Purchasing of goods

11.22-18 Purchase of goods or merchandise is not a PE constituting activity, if the activity is meant for the head office abroad, not for the PE itself if it exists for resale or processing. All activities mentioned in paragraph 4 lose their preparatory or auxiliary character if they serve the core business activity, with the exception of the activity of purchasing. That activity would not be taxable, even if other business activities are also carried on through that place (*see* OECD Commentary, article 7, paragraph 30). Paragraph 5 of article 7 of the Indo-Norwegian treaty provides "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise." The activity of purchase would not lose its auxiliary character, even if combined with other business activities. It is because purchasing activity for sales outside a country is not considered to have that country's source since the mere purchase of goods does not increase the value of the enterprise. The activity would neither be a PE nor any profits of an already existing PE be attributed to it. If, however, the purchased material is subjected to some kind of processing, a PE would be constituted; for examples, hides purchased in a country processed there for resale [*see Transvaal Associated Hide and Skin Merchants Ltd. v. CIT, Botswana* 29 South African Tax Cases 97 (1967)].

Exemption of purchasing activities is not only confined to stock-in-trade or raw material but also to other assets say for example securities.

Permanent establishment - Agency PE

11.23 Paragraphs 5 to 7 of article 5 deal with special cases where the foreign enterprise functions not directly but through some other agency. An enterprise is treated as having a PE if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business within the meaning of paragraphs 1 and 2. A considerable part of the international trade is conducted through agents. One type of agent is deemed to create a permanent establishment, who has the authority to conclude contracts (other than purchase contracts) on behalf of the enterprise or who habitually exercises this authority. Such are dependent agents. Agents of independent status acting in the ordinary course of their business are excluded. What the expression "agent" means is discussed later with somewhat detail. Mere agency for acting on behalf of a foreign enterprise is not enough to constitute a PE. For that purpose the agent must fill orders from a stock of goods or habitually exercise an authority to conclude contracts on behalf of or in the name of the foreign enterprise. To bring an agency within the terms of "a place of management" or "a branch" so as to constitute a PE, it must be shown that there exists an organisation identifiable as the "locus" of operations, something physical and separately identifiable as the place of business belonging to the non-resident. The person (agent) in himself represents a "fixed place of business". For that matter a question has to be asked whether the agent is of independent status as defined in paragraph 7 (discussed later), and if the answer is in the negative, then another question, whether he has, and exercises, the authority to conclude

contracts in the name of the enterprise, and if the answer is in the affirmative, then another question, whether he is a mere agent with respect to goods or merchandise for storage or display or, for processing by another enterprise or, for the purpose of the purchase or, for the purpose of carrying any other activity (for the enterprise) of preparatory or auxiliary character. The negative answer to the last question will render him PE. Even if he has no such authority, he is still deemed to be PE if he habitually maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise. Thus for being a PE an agent may not require any authority. He can act without it. Thus, an agent is deemed to be permanent establishment, if he is not independent and

- ...◆has and habitually exercises an authority to conclude contracts in the name of the enterprise unless the activities of such person are limited to those mentioned in paragraph 4 [paragraph 5 (a)] ; or if he has no such authority, but
- ...◆habitually maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise [paragraph 5 (b)], or
- ...◆in case it is neither but habitually secures orders wholly or almost wholly for the enterprise (*see* Indian treaty with Armenia, Hungary, Slovenia, Sudan, Uganda and Malaysia)

The second condition is only provided under the UN Model Convention. It is because the basic rule under that Convention deems maintenance of a stock of goods for delivery to be a core business activity, and not preparatory or auxiliary as done under the OECD Model Convention [*see* paragraph 4(b) which only deems preparatory or auxiliary activity of maintenance for storage or display and not delivery]. The only real criterion for agency PE, according to OECD Commentary, 1963 is the nature of the authority entrusted to the agent. Thus OECD Model convention therefore provides only one criterion for the agency PE, *i.e.*, the authority to conclude contract (*see* paragraph 5 of the OECD Model Convention).

As for the last requirement, it may be said that an agent who is required to devote the whole of his activities to one enterprise should constitute a PE [*see* League of Nations, Fiscal Committee Report (1930)]. The UN Commentary also suggests that the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise. Such an agent is deemed to be a dependent agent. The UN Commentary also states that an agent who is working almost solely for one principal has lost his independent character. The OECD Commentary also provides that independent status is unlikely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time ; but, however, this fact is not by itself determinative (paragraph 38.6 of the Commentary).

Agency PE and the basic rule

Carrying on business is one thing and establishing a place of business is another - *Lord Advocate v. Huron & Erie Loan & Savings Co.* 1911 SC 612 (1st Div.). Establishment of a place of business connotes some visible and physical connection with a locality. If an enterprise has a specified and identifiable place at which it carries business there, it can be said to have established a place of business. Such a place may be termed 'office' or a 'local habitation'. The establishment of such a 'local habitation' may be intended to have a sort of permanence, which cannot be inferred if a business is carried through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. But, when the activities of such an 'agent are devoted wholly or almost wholly on behalf of that enterprise, he is not considered an agent of an independent status. Such activities may relate to negotiations of terms of sale, carrying on survey of goods imported, arranging for the delivery of goods sold, collection of the price of the goods sold. All such activities are trading activities and the agent undertaking them on behalf of a foreign enterprise is the manifestation or projection of that enterprise.

The ingredients of the basic PE rule could be traced in an agent PE. The words "fixed place of business through which business is carried" require that an enterprise must conduct the business activity through the place of business (business connection) which must be linked to a specific geographical point (location test). Carrying on business activity is all important, whether done through the objects such as offices, factories, machineries or through personnel, human beings or agents. That object is the place of business. In authorising a person (whether an individual or corporation) to carry on business, the enterprise establishes a "place of business". Thus, office,

factory or machinery etc. is one type and "agent" is another type of place of business. Therefore, location test is also of different kind. The physical location with reference to a geographical point in the one is modified for the other and replaced by the personal connection of the agent to the territory of a State. Location of an agent in the territory of another State satisfies the geographical "location test" of the basic PE rule. The place of business test and the fixation *i.e.*, the location test of the basic rule are met by the personal connection test of the agency rule. The enterprise may not have a fixed place of business within the meaning of paragraphs 1 and 2, but still have a PE in a person acting for it (*see* OECD Commentary, article 5, paragraph 31).

For a PE, the activity of business must have a nexus to the territory of the country where income can be said to have arisen and thereby assessed. Under the basic rule, territorial connection is provided by the distinct place rooted to the soil such as building (office, factory, workshop, mine) or a specific geographical point; under the agency PE, by the presence of agent in the country. The important thing is the foreign enterprise presence in and the business connection with the country of source, which under the basic rule exists through a place and under the agency rule through an agent.

As regards business activity, the enterprise can be said carrying it on if it authorizes the agent to conclude contracts on its behalf who habitually exercises that authority. "Habitually exercises" means exercising authority repeatedly and not merely casually. The test of basic PE rules are modified for the agency PE rule. The modified rules are provided in paragraph 5 of the Model Convention. That paragraph simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a PE within the meaning of paragraphs 1 and 2 (subject to provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5 (*see* OECD Commentary, article 5, paragraph 35). For example, if an enterprise has a sale office operated by its agents who do not have the authority to conclude contracts would still be considered to have PE because it has a place of business (an office) under the basic rule. Even if the enterprise does not have its own but has a right to use the place where the agent carries on the business activity, PE is constituted under the basic rule and the agency clause is of no relevance.

The requirement of paragraph 5 of the OECD Model Convention is that the agent who is dependent upon the instructions from the enterprise maintains a stock of goods for delivery on behalf of the enterprise or has the authority to conclude agreement on its behalf.

Agency PE - Dependent agent

A person would constitute a PE under the agency clause if he is dependent upon the instructions from the enterprise acting on its behalf—

- ...◆has the authority to conclude contracts and that
- ...◆that authority is habitually exercised, or
- ...◆without such authority delivers goods or merchandise on behalf of the enterprise from the stock habitually maintained by him (UN Model Convention only).

An independent agent acting on behalf of the enterprise and not acting in the ordinary course of his own business with the above authority is also a PE. The distinction between a dependent and an independent agent appears to be this, the former operates as an integral part of the principal's organization whereas the latter conducts business activities of the enterprise as his own business. Such as a broker or a commission agent or agent of similar nature conducting his own business activities.

Article 5(5) of the Model Convention provides that an agent is a PE if he "has an authority to conclude contracts in the name of the enterprise" The expression "to conclude contract" has not been defined; whether it could mean negotiation or signing or both. In deciding, what is to be seen where core business activities are performed. Normally it is where the contract is negotiated. If signing is mere formality and has no material influence on the negotiated obligations, then conclusion of negotiations is the conclusion of a contract. The agent could be said to have concluded the contract. Thus, a person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to be exercising his authority in that State, even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given the power of representation (*see* OECD Commentary, article 5, paragraph 33). The agent may be authorised to negotiate the contract on the terms and conditions as having been already instructed or as to be approved later. In the former case, he may be said, and in the latter not, to have been authorized to conclude. Thus, if negotiations are

subject to approval, the contract is concluded where it is approved and signed. Soliciting and negotiating contracts which are subject to approval are not conclusion of contracts. Arvid A. Skaar illustrated as follows in his book "Permanent Establishment":

"International tax practice shows a number of cases where tax authorities have sought to establish PE taxation of agents whose activity is limited to solicitation of contracts or marketing of the principal's products. A Canadian Court decision [*American Wheelabrator and Equipment Corporation v. M.N.R.* in 4 Can. Tax App. Bd. 345 (1951)] concerned an agent whose task was to interview prospective customers, and to notify their requirements to the company's office in the US. The contracts were negotiated and concluded by the US resident employees of the company. Consequently an agency PE was denied. A Norwegian administrative decision dealt with the authorization of a travelling agent to act on behalf of a Danish company in Norway (The Ministry of Finance in Utv 1972, at 518). The agent's task was to seek out possible customers, demonstrate the company's products and take orders for subsequent approval by the principal in Denmark. The reason for the Ministry of Finance's denial of an agency PE was that the authorization was limited to receiving buying offers from the customers, as opposed to having power to commit the company. In US administrative practice (IRS in Ltr. Rul. 81-31-059) it was considered whether a marketing agent of a foreign enterprise constituted an agency PE. The agent did not have the pricing authority, and he had no right to accept or reject orders. Agency PE was denied. In French practice [Conseil d'Etat of July 25, 1980 (Req. No. 11,535)], an agency PE has been considered, but denied, for an agent whose activity was limited to receipt and delivery of stocks of goods. An agency PE has been denied for agents who only keep a collection of goods for demonstration (unpublished letter of November 3, 1952, from the Norwegian Ministry of Finance to the taxpayer's attorney). A denial of PE must also apply to activities which include a limited authority to commit the principal, for instance keeping and running of an office for the principal, collecting outstanding claims, etc. as long as it does not include power to conclude business agreement.

Negotiation of contracts is also insufficient if the draft contracts are subject to genuine subsequent approval by their principal. An agency PE is constituted, however, when the approval of the contract is a pure formality and not a real part of the negotiations."

For tax treaty purposes, an agent can be said authorized if his actions are believed by a third party to be based on authorization. That belief may be induced by the agent's position in the principle's organization and conduct of the principal. If the conclusion of a contract is based on such belief, the principal is obliged to respect irrespective of whether or not the agent has been specifically authorized or occupying a specific position in the principles organization. Lack of active involvement by an enterprise in the transaction may be indicative of the grant of authority on an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions (*see* OECD Commentary, article 5, paragraph 32.1).

Permanent establishment - Agent has the authority to conclude contract - Relating to essential business operations

11.23-1 The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. If the agent is authorized to conduct preparatory or auxiliary activities, as defined in paragraph 4 of article 5, he cannot be said to be constituting a PE (*see* OECD Commentary, article 5, paragraph 33). The requirement of the agent authority to conclude contract is thus limited to contracts which relate to the essential business operations of the enterprise and contracts relating to ancillary activities are not covered. An illustration is provided by the Technical Explanations on the US Model Convention in the following terms:

"For example, if the agent has no authority to conclude contracts with its customers for say, the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise's business equipment used in the agent's office, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly".

Paragraph 5(a) uses two expression "has" and "habitually exercises" an authority to conclude contracts on behalf of the enterprise. While the expression "has" may have reference to the legal existence of such authority on the terms of the contract between the principal and the agent, the expression "habitually exercises" has certainly reference to

a systematic cause of conduct on the part of the agent. If an agent is habitually concluding contracts on behalf of the enterprise without any protest or dissent, it could be presumed that the principal has agreed implicitly to be the agent exercising power—*TVM Ltd. v. CIT* [1999] [102 Taxman 578](#) (AAR - New Delhi).

An enterprise carrying on business through an agent who has no independent status is held to be having a PE, provided any of the above conditions is satisfied. He is deemed so to be if he has, and exercises, the authority to conclude contracts in the name of the enterprise. But even the existence of such authority will not make him a PE (i) if he is mere agent for the purposes of purchase of goods or merchandise. The Authority for Advance Rulings in the *TVM Limited* [1999] [102 Taxman 578](#) (AAR-New Delhi) observed in the context of India/Mauritius treaty, "The conclusion seems inevitably that even non-independent agent can be deemed to be a PE only if he can act independently in the matter of concluding contracts on behalf of the principal, on his own, freely and without control from the latter".

Contract in the name of the enterprise

The agent authority is to conclude the contract in the name of the enterprise. The expression "in the name of the enterprise" is not to be read literally. It would mean contracts which are binding on the enterprise even if they are not actually in its name (*see* OECD Commentary, article 5, paragraph 32.1). A person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority in that State even if the contract is signed by another person in the State in which the enterprise is situated (*see* OECD Commentary, article 5, paragraph 33). The agent's activity, therefore, "involves the enterprise to a particular extent in the business activities of the State concerned (*see* OECD Commentary, article 5, paragraph 32)". "In the name of enterprise" is not so relevant as the binding nature of the contract. It is of no matter that the contract is in the name of the enterprise or the agent so long as the enterprise is bound by it. When a person "has sufficient authority to bind the entrepreneur's participation in the business activity (OECD Commentary, article 5, paragraph 32)", his this authority cannot be curtailed by the formality of the contract being not in the name of the enterprise. When a person authorizes another to sign for him, the signature of the person signing is the signature of the person authorizing (*see Queen v. Justice of Kent* [1873] 8 QB 305, 307; also *see Rao Bahadur Ravulu Subba Rao v. CIT* AIR 1956 SC 604, (1956) [30 ITR 163](#)). Thus contract in the name of the agent is also the contract in the name of the principle, if the agent has acted within the scope of his authority. In whose name it is made is not material as whether the agent has sufficient authority to bind the enterprise's participation in the business activities of the State concerned. The only thing is that the "agent" does not act as his own principal; the transaction involved should be one contract in the name of the principal between the principal and the third through the agency of the agent and not two, one a purchase contract between the principal and the agent and the second a sale contract between the agent and the third party in the name of the agent. The agent creates a legal obligations for the principal without being a part of deal himself.

Permanent establishment - Habitually exercises authorityPermanent establishment - Habitually exercises authority

11.23-2 If there is an agent who has been authorised by the foreign enterprise to conclude contracts on its behalf (unless such activity is limited to the purchase of goods or merchandise for the enterprise); and who exercises such authority habitually, the foreign enterprise could be said trading within and having a permanent establishment. Conclusion of agreement done repeatedly or persistently in exercise of authority is the requirement for that person to be taken permanent establishment of the enterprise.

If an enterprise chooses to keep an agent in a State, who obtains orders and who causes goods to come over to customers in that State and through whose hands the money pass and through whom all such arrangements such as keeping an establishment, securing orders from the customers, collection of money from them and keeping a banking account in that State are made that enterprise can be said to be carrying on trade in that State—*Pommery & Greno v. Aphorpe* [1886] 2 TC 182.

Normally a trade is exercised at a place where a contract is made - *Maclaine & Co. v. Eccott* [1926] AC 424 (HL). A contract represents legal relations resulting from the act of parties, and means a total obligations in law resulting from the parties' enforceable agreement. Total obligations follow from the enforceability of the promises. The contract does not contemplate simply the act of promising but obligations arising therefrom.

Repeated, persistent and similar acts, conveying an idea of continuity, on behalf of the non-resident, would hold him the latter's permanent establishment, as the use of such expressions as 'habitually exercises', 'maintains', 'regularly fulfils' convey. Such expressions convey some kind of frequency or repetition of, or permanence of things done by the person on behalf of the foreign enterprise.

'Habitually' - The expression 'habitually' means 'repeatedly' or 'persistently'. It implies a thread of continuity stringing together similar repetitive acts. Repeated, persistent and similar but not isolated individual and similar acts are necessary to justify an inference of habit. It connotes frequent commission of act or an aggregate of similar acts. Because the idea of 'habit' involves an element of persistence and a tendency to repeat the acts of the same class or kind, if the acts are not of the same class or even if they are of the same kind when they are committed with a long interval of time between them, they cannot be treated as habitual ones—*Vijay Narain Singh v. State of Bihar* AIR 1984 SC 1334.

'Maintains' - The inherent concept in the word 'maintenance' involves a sense of continuity, periodicity or permanence. Maintenance of stock of goods or merchandise connotes the idea of possessing it continually or somewhat with permanence, so that for fulfilment of the orders on behalf of the foreign enterprise the agent draws from such stock.

Regularly - 'Regularly' is characterised by reasonable punctuality; that is to say, happening on regular times or intervals. The 'regularity' contemplated may not be punctuality of clock-wise precision and exactitude, but it must reasonably conform with substantial proximity to the sequence of time or intervals at which—*Mranalini B. Shah v. Bapalal Mohanlal Shah* AIR 1980 SC 954, delivery of goods or merchandise is made. The delivery of goods sold to a purchaser is one aspect of the trading activity—*M/s. International Ore & Fertilizers (India) (P.) Ltd. v. Employees' State Insurance Corpn.* AIR 1988 SC 79.

Several agents- whether one permanent establishment

11.23-3 An enterprise may be having many agents in a state, each performing some part of the business activity. A question arises whether the enterprise has as many PE as the number of agents if each qualifies the requirements of PE agency, or has only one and the business activities of all are taken together and identified as one, including of those who are conducting only preparatory or auxiliary activities. They are to be taken as one if they are under one local management or conduct the business activity as an integrated whole.

Permanent establishment - Insurance agent

11.23A An insurance enterprise carries on business of insuring risks. Collection of premium to maintain a insurance policy already undertaken covering the risks, is not doing the business of insuring risks. Insurance business means the business of effecting contracts of insurance covering risks of loss of goods or limb or life. It is subject to payment of premium. Effecting contract is the essence of insurance business. An insurance business is carried where such agreement is effected. An insurance company has a PE if it has a fixed place of business within the meaning of paragraph 1 of article 5 or if it carries on business through a person within the meaning of paragraph 5. Mere collection of premium in pursuance of the contract already effected, is neither.

Foreign insurance companies sometimes may not have fixed place of business in the other state or carry its insurance business through a dependent agent within the meaning of paragraph 5 and consequently not taxed in that state in respect of income from the insurance business. Person do not meet the requirement of PE in terms of paragraph 1 or paragraph 5 of article 1.

The position of an insurance agent is peculiar. He may be independent and also dependent. In both situations he fails to qualify for PE. He may pursues the activity independently within the course of his ordinary business be authorized to conclude insurance policies, but he cannot be termed PE because of the failure of the dependency test. He may be dependent but not authorized to conclude contracts ; only authorized to collect premiums.

Insurance agents are independent agents with no authority to conclude contracts in the name of the principal. On that account, income resulting to an insurance company through the business activities of such agents by way of premium collection and risks covering may not be taxed because of the absence of PE. The insurance company cannot be said to have a business presence in that state either through its employees or agents. The source State may be deprived of its legitimate share of the revenue.

The UN Model Convention made a special provision in respect of insurance business. Reason for doing so could be traced in paragraph 39 of the OECD Commentary. It provides : "According to the definition of the term

'permanent establishment' an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have permanent establishment in the other State if they collect premium in that other State through an agent established there - other than an agent who already continues a permanent establishment by virtue of paragraph 5 - or insure risks situated in that territory through such an agent". The provision to that effect was not made in the OECD Model Convention and the decision whether to include it is left to the Contracting States concerned. It is, however, included in the UN Model Convention to obviate the possibility of the source State losing revenue in respect of income arising to an insurance company as a result of its large scale - business activity in that State.

A dependent agent constitutes a PE in terms of paragraph 5. An independent agent also constitutes if he is acting outside the course of ordinary business. An insurance agent may not be either. He may be subject to instructions of the principal but those instructions may not go to the level of merging of the business interests between the agent and the principal, *i.e.*, the power to instruct does not exceed the competence which is an element of PE constituting agency. He may be authorized to conclude insurance policies but he does so independently within the course of his ordinary business. He may be legally dependent but not economically or *vice versa*; he may be both but acting within the course of ordinary business.

The UN model provides that an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a PE in the other Contracting State if it collects premiums in the territory of that other State or insures risks therein through a person other than an agent of an independent status in terms of paragraph 7.

The provision is a modification of the agency clause in paragraph 5. A dependent agent not authorized to conclude insurance policies, but authorized to collect premiums or insuring risks is deemed a PE. Collection of premium or insuring risks are limited but very significant in the insurance business and PE constituting even if under the basic rule of auxiliary character. There are two exceptions; one independent agents and the second agents dealing with reinsurance.

Permanent establishment - Agent meaningPermanent establishment - Agent meaning

11.24 A considerable part of the international trade is conducted through agents. When and to what extent the presence of agents in other countries could be taken a projection of business enterprise, has been a matter of agreement. An agent is one who represents, acts for and accounts to another. Agency is the relationship that exists between two persons one of whom, the principal expressly or impliedly consents that the other, the agent, similarly consenting, should represent him or act on his behalf. The use of the phraseology in the terms of contract cannot in any way be conclusive and what one has to look for is the substance and not the form thereof, and that mere use of the words 'principal' and 'agent' employed in an agreement would not necessarily mean that the principal was carrying on the business through his agent, if the basic element of control or carrying on the business and sharing of the profits and the losses were absent—*Khas Benedih Colliery v. CIT* [1974] BBCJ 440 (Pat.). Mere use of the terminology of the principal and agent may at times, far from being conclusive, may be misnomer. One has, therefore, to go to the root and substance of the contract and not merely to its form and name, because, otherwise, it would be open to the parties to camouflage the substance of an agreement by merely employing the labels of principal and agent—*CIT v. H.D. Agarwala & Sons* [1988] [169 ITR 617](#) (Pat.) (FB).

Agency describes the relationship between two persons when a person, known as 'agent', is empowered to do an act for another or to represent him in dealings with a third person. The person for whom such an act is done, or who is represented, is called the 'principal'. The authority of an agent may be express when it is given by words spoken or written and implied when it is to be inferred from the circumstances such as things spoken or written or the ordinary course of things.

An agent's authority has been described variously, which binds the principal; such as "usual authority", "ostensible authority", "agency by estoppel", or "implied authority". "Usual authority" means authority attaching to a particular job, *i.e.*, an authority which an agent of a particular type is reasonably assumed to have, and is not dependent on representation by the principal. "Ostensible authority" is the apparent authority. "Agency by estoppel" refers to where there has been some holding out of the agent's authority on which the third party relied.

The expression "implied authority" is used to describe the relationship between the principal and the agent. Relationship of the agent *vis-a-vis* the principal is known as implied authority and his relationship *vis-a-vis* the third party, as ostensible authority. Both may be coterminous, but not the same (*see Waugh v. Clifford* [1982] Ch 374).

Ostensible agency

Ostensible authority is a legal relationship between the principal and the contractor created by representation, made by the principal to the contractor, intended to be and in fact acted upon by the contractor, that the agent has the authority to enter on behalf of the principal into a contract of the kind within the scope of the apparent authority so as to render the principal liable perform any obligations imposed upon him by such a contract (*see Freeman & Lockyer v. Buckhurst Properties (Mangal) Ltd.* [1964] 2 QB 480). The agent must not purport to make the contract as principal himself. The ostensible authority is a kind of estoppel involving principal making a representation, third party relying upon it and altering position resulting from such reliance (*see Rama Corporation Ltd. v. Proved Tin and General Investments Ltd.* [1952] 2 QB 147). The representation must originate from the principal and not from the agent (*Armagas v. Mundogas* [1986] 2 All ER 385).

Usual authority

Usual authority, *i.e.*, the authority attaching a particular job, is a particular type of ostensible authority when a principal allows the agent to act in a particular capacity. It would be taken that the agent acting in that capacity has the authority to do all things which fall under that capacity. If the act falls outside that, the agent cannot be said to have the authority to do that act; and the principal is not bound by it. For example, in case of a solicitor, it would be considered normal if he gives an undertaking on behalf of his client if there is some underlying transaction in which he is concerned as a solicitor, *i.e.*, which is a part of the usual business of a solicitor (*see United Bank of Kuwait v. Hammond : City Trust Ltd. v. Levy* [1988] 3 All ER 418 CA) The solicitor may have the authority to carry out a convincing transactions (*Lloyd v. Grace Smith & Co.* [1912] AC 716), or to arrange a loan (*Uxbridge Permanent Benefit Building Society v. Pickard* [1939] 2 All ER 344), but not guaranteeing a loan. The third party is concerned as to whether the transaction appears to be of a kind that is within the ordinary authority that the agent is held out as having, not whether it is in fact a transaction of that kind.

Agency by estoppel

When a person is understood to represent or act for the person who has placed that person in a situation in which according to the ordinary usage he is understood, he is agent by estoppel. Thus, where a person by words or conduct represents or permits it to be represented that another person has the authority to act on his behalf, that such other person is an agent by estoppel. The ingredients of such agency are : representation, reliance on the representation, and alteration of the position from such reliance. An apparent agency is as effective as an agency deliberately created and the principal is bound by the act or representation in both situations.

Agency for treaty purposes

The expression "agent" for the purposes of article 5(5) of the Model Convention is limited to "persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in the business activities in the State concerned" (paragraph 32 of the OECD Commentary, article 5).

Therefore, paragraph 5 proceeds on the basis that only person having an authority to conclude contract can lead to permanent establishment for the enterprise maintaining them. In such a case, the person has a sufficient authority to bind the enterprise's participation in the business activity in the State concerned (*see OECD Commentary, article 5, paragraph 32*).

Permanent establishment - Agents - DependentPermanent establishment - Agents - Dependent

11.24-1 The OECD/UN Model draft contemplates two types of agents, dependent and independent.

The expression "dependent agent" has been defined in OECD Commentary (paragraph 32, article 5) as "persons, whether or not employees of the enterprise, who are not independent agents falling under paragraph 6 (Model Convention). Such persons may be either individuals or companies and need not be residents of, nor have the place of business in, the State in which they act for the enterprise.... who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in the business activities in the State concerned.... (with) sufficient authority to bind the enterprise's participation in the business activity in the State concerned...." Dependent agent is—

1. a person (either individual or company not necessarily being resident of, or having a place of business in, the state in which he acts for the enterprise) who is not an independent agent in terms of paragraph 6 of the OECD Model Convention.
2. who involves the enterprise to a particular extent in the business activity of the state,
3. has sufficient authority to bind the enterprise's participation in the business activity in the State concerned.

Dependent agent has been defined negatively to mean a person who is not an independent agent as defined in paragraph 6 of article 5 of the OECD Model Convention (other ingredients in 2 and 3 above have already been discussed). Independent agent according to that paragraph is a broker, general commission agent or any other agent of an independent status, provided such a person is acting in the ordinary course of his business (discussed in paragraph 11.24-4A). From that definition, it could be said that authorization to conclude contracts to bind the principal in the business activity of the State coupled with agent's legal dependence as understood as dependence upon the instructions from the principal is the basic requirement for the dependent agent to be taken as PE. Such a relationship suggests merging of business interests of the agent and the enterprise, which is evidenced by the power of the enterprise to issue detailed instructions or exercise comprehensive control, and the agent bearing no entrepreneurial risks with very little commercial discretion. These are discussed below.

Dependence Test

The test of dependence has been provided in paragraph 38 of the OECD Commentary, which reads as follows :

"Whether a person is independent of the enterprise depends on the extent of the obligations which this person has *vis-a-vis* the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents."

The disqualification of an independent agent is another test of dependency, *i.e.*, not "acting in the ordinary course of his business" (*see* paragraph 6 of the OECD Model Convention)

An agent can be said dependent if-

- ...◆his commercial activities for the enterprise are subject to-
 -■ detailed instructions or
 -■ comprehensive control;
- ...◆he does not bear the entrepreneurial risk;
- ...◆he is not acting in the ordinary course of his business.

The above are indicative of merging of business interest of the enterprise and the agent and hence agent's dependency. Conversely, independence is indicated by the wide discretionary power, sharing of entrepreneurial risks and performing an activity which is within the course of agent's ordinary course of business.

The above criteria suggest that a dependent agent is to be integral part of the business of the principal. There are, therefore, agents called dependent agents who operate as integral part of the principal's organization and independent agents who conduct business activities as their own business. An extreme example of detailed instructions is found in the case of an employee where the employer has the power to give detailed instructions (In *Secretary for Inland Revenue v. Downing* [1975] (4) South African Law Reports 518) a stockbroker who had complete autonomy as regards the taxpayer's investment portfolio was held to be an independent agent operating within the ordinary course of his business.

Principal right to give instructions is a feature of any agency which creates an obligation ; but for treaty purposes it must be something more than the normal which requires the merger of the business interests between the agent and the principal and thus curtails substantially the discretionary power of the agent. Dependent agent's interest must merge with the business of the principal.

Likewise comprehensive control means absence of any discretionary power as regards commercial activities for the principal. The principal must have the power to regulate or exercise directing influence over the business activities of the agent, over the functioning and the policy as regards PE-constituting obligations. Comprehensive control means control which is all - embracing and wide in scope, inclusive. It should be more than the usual of normal agency. Such a comprehensive control is normally found when an agent deals wholly or almost wholly one

enterprise UN Model (paragraph 7) deems an otherwise independent agent to be dependent if he deals with only one client, if the transactions between them are not at arm's length. One client indicates merger business interests.

Another indication of dependency is the agent not bearing entrepreneurial risks (*see* paragraph 38 of the OECD Commentary, article 5). Business cannot be said to have been merged, if risks are shared.

Arvid A. Skaar observed as follows in his book "Permanent establishment"

"An agent is dependent upon the principal if his business interests have merged with the interests of the principal. The mere right of the principal to instruct the agent is not enough. However, lack of discretionary power of attorney on the part of the agent established through the principal's extensive right to instruct the agent, to control business or sanctions upon him will indicate dependency. These circumstances prove that the agent has a narrow discretionary power of his own. Another important indication is the principal's support of the business of the agent, for example through machinery or equipment, or by the agent using office facilities owned or rented by the principal dependency may also be indicated by the number of clients that the agent has. An agent who has devoted all or almost all his time to one client is likely to be dependent agent. This is expressly stated in the UN Model treaty, but also be the rule under the OECD based treaties."

The question whether an agent is both legally and economically independent of the enterprise, is to be answered by asking a question whether the agent is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise and another, whether the agent bears the business risk. Positive answer to the first indicates legal dependence and to the second, economic dependence (the matter is discussed further in paragraph 11.24-4A).

If the agent is independent and acting in the 'ordinary course of business' there is no permanent establishment of the non-resident. Where an agent is not independent, the non-resident may have a permanent establishment. By virtue of the permanent establishment certain income associated with or derived through that permanent establishment may be subject to tax. The dependent agent has an authority to conclude contracts on behalf of the enterprise and he habitually exercises this authority in the country where he is located, *i.e.*, the agent has a legal authority to bind the enterprise or who in the absence of such authority habitually maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise. The agents of independent status acting in the ordinary course of their business are excluded from the scope of permanent establishment. Nor, will the fact that the parent company or a subsidiary of an overseas company being resident in the other state necessarily mean that overseas company is deemed to be a permanent establishment. However, care needs be taken when dealing with some of the older agreements, as the parent/subsidiary exclusion will not apply if the company manufactures, assembles, or processes, packs or distributes any goods; or where it carries out any mining, quarrying, forestry, or other natural resource extraction, or breeding management of livestock, on behalf of or to the order of the overseas company.

However, agreements entered into after 1980 follow much more closely, in format and content, the 1977 of the OECD Model or 1980 UN Model, Even so, care must still be exercised as the generalisation referred to above may not apply to the relevant agreement.

Permanent establishment - Agency or selling of goodsPermanent establishments - Agency or selling of goods

11.24-2 In case of *Bhopal Sugar Industries Ltd. v. STO* [1977] 40 STC 42 the Supreme Court observed that a mere formal description of a person in a contract as an agent or a buyer is not conclusive, unless the context shows that the parties clearly intended to treat a buyer as a buyer and not as an agent and that one must look to the substance of the transaction as disclosed in the contract in order to determine the nature of the contract.

Commission agents 'appear to resemble independent parties rather than agents'. As regards the principal, a commission agent seems to be a seller of goods as regards the third party as buyer of goods. The relationship between a principal and a commission agent is, therefore, a mixture of that involved in agency and that involved in the sale of goods. The contracts with commission agents do not follow a single pattern and it is always necessary to bear in mind, while considering such contracts as to what are the terms of a particular contract.

The following considerations should be taken into account for deciding whether the relationship between the two parties is of agency or of seller and buyer of goods:

- ... ♦ The true relationship has to be gathered from the nature of the contract, its terms and conditions. The terminology used by the parties such as 'agents' or 'sale distributors' or 'buyers' is not decisive of the legal

relationship. The substance of the transaction as disclosed in the contract has to be looked into in order to determine the nature of contract - [1977] 40 STC 42.

- ...◆ When one party transfers goods to another for a price which is paid or is promised to be paid, the transferee is liable to the transferor as debtor for the price to be paid and not as an agent for the proceeds of the sale - *Sri Tirumala Venkateswara Timber & Bamboo Firm v. CTO* [1968] 21 STC 312 (SC), *Gordon Woodroffe & Co. (Madras) Ltd. v. Shaik M.A. Majid & Co.* AIR 1967 SC 181.
- ...◆ The essence of agency to sell is the delivery of goods to a person who is to sell them not as his own property but as the property of the principal who continues to be the owner of the goods and will, therefore, be liable to account for the sale proceeds - *Tirumala Venkateswara Timber & Bamboo Firm v. CTO* [1968] 21 STC 312 (SC), *Gordon Woodroffe & Co. (Madras) Ltd. v. Shaik MA Majid & Co.* AIR 1967 SC 181.
- ...◆ In the case of a mercantile agent, the accepted practice is that he has control over or possession of the goods to pass the property in and title to the goods. If this is so, undoubtedly when a commission agent sells goods belonging to his principal with his authority and consent and without disclosing to the buyer the name of the owner, there is certainly a transfer of property in the goods from the commission agent to the buyer. The relationship between the commission agent and its principal, however, continues to be of agency - *Becker Gray & Co. v. CIT* [1983] [139 ITR 293](#) (Cal.) and *Punjab State Co-operative Supply & Marketing Federation Ltd. v. CIT* [1981] [128 ITR 189](#) (Punj. & Har.).
- ...◆ If the agreement between the parties suggests that if any loss is suffered by the alleged agent in the transaction of sale, he is to be indemnified by the principal because he is not the owner of the goods, the relationship of agency between them is inferred - *Becker Gray & Co. v. CIT* [1983] [139 ITR 293](#) (Cal.) and *Punjab State Co-operative Supply & Marketing Federation Ltd. v. CIT* [1981] [128 ITR 189](#) (Punj. & Har.).

In a contract of sale, title to the property passes on to the buyer on delivery of goods for a price paid or promised. Once this happens the buyer becomes the owner of the property and the seller has no vestige of title left in the property. The concept of sale has undergone a revolutionary change, having regard to complexities of modern times and the expanding needs of the society which had made departure from the doctrine of *laissez faire* by including a transaction within the fold of a sale even though the seller may, by virtue of an agreement, impose a number of restrictions on the buyer, e.g., fixation of price, maintenance of accounts in a particular manner and submission thereof. These restrictions *per se* would not convert a contract for sale into one of agency, because, in spite of these restrictions the transaction would still be a sale, subject to all the incidents of a sale. A contract of agency however differs essentially from a contract of sale inasmuch as an agent on taking delivery of the property does not sell it as his own property but sells the same as the property of the principal and under his instructions and directions. Furthermore, since the agent is not the owner of the goods if any loss is suffered by the agent, he is to be indemnified by the principal. This is another dominating factor which distinguishes the agent from a buyer - *Becker Gray & Co. v. CIT* [1983] [139 ITR 293](#) (Cal.) and *Punjab State Co-operative Supply & Marketing Federation Ltd. v. CIT* [1981] [128 ITR 189](#) (Punj. & Har.).

Permanent establishment - Agent or sales representative

11.24-3 The existence of sales representative of a foreign enterprise, does not by itself constitute a permanent establishment, unless the representative has an authority to conclude contracts or he regularly delivers goods or merchandise on behalf of the foreign enterprise. In the absence of such authorities, the representative is not deemed to be permanent establishment of a foreign enterprise if his activities are limited to purchase of goods or merchandise on behalf of or maintains stock belonging to it, or is engaged in the collection of information or for making advertisement or any other ancillary, auxiliary or support functions on behalf of the foreign enterprise. However, if a person, habitually secure orders wholly or almost wholly for the enterprise, he is deemed to be a PE (*see* Indian agreement with Armenia, Malaysia, Hungary, Slovenia, Sudan and Uganda).

Thus, a sales representative who has no authority to conclude contracts for his employer, nor holding a stock of merchandise from which he regularly makes delivery, is not a permanent establishment - *Ronson Art Metal Works (Canada) Ltd. v. Minister of National Revenue* 10 DTC 440 and *American Wheelabrator & Equipment Corp. v. MNR* 51 DTC 285. But if he has an authority to contract and accept orders on behalf of the foreign enterprise, he represents a permanent establishment - *Panther Oil & Grease Mfg. Co. of Canada v. Minister of National Revenue*

11 DTC 494. Presence of an agent acting own behalf of the foreign enterprise is not enough. If the agent trades on his own behalf, without authority to fill orders on behalf of the foreign enterprise form a stock of goods, he is not a permanent establishment.

Like an agent, the sales representative must have an authority to conclude contract or fill orders on behalf of the foreign enterprise from the stock of goods. The office used by the sales representative for purpose of advertisement or collection of information does not constitute PE. In *Ronson Art Metal Works (Canada) Ltd. v. M.N.R.* 10 DTC 440, the appellant company had its head office in Toronto. It has a nation wide business of manufacturing and selling lighters and their accessories. The company sold its products directly to the distributors and retail chain stores in the province. It had no branch office in the province of Quebec. It had only local sale representative. The salesman had no stock or office, and no authority to contract. The orders taken by him were sent to the head office in Toronto where they were channelled through various distributors. The court held that the sales representative did not represent PE in *American Wheelabrator & Equipment Corporation v. MNR* 51 DTC 285. But where he has an authority to accept orders on behalf of a foreign enterprise, the PE is deemed - *Panther Oil Grease Mfg. Co. of Canada v. M.N.R.* 11 DTC 494 (also see Indian agreement with Armenia, Hungary, Slovenia, Sudan & Uganda).

Permanent Establishment - Independent agentsPermanent Establishment - Independent agents

11.24-4 Independent agent according to paragraph 6 of the OECD Model Convention (paragraph 7 of the UN Model Convention) is a broker, general commission agent or any other agent of an independent status, provided such a person is acting in the ordinary course of his business. An independent agent generally means one who, exercising an independent employment, contracts to do a piece of work according to his own methods and without being subject to control of his employer except as to the result of the work (*see Donroy Ltd. v. United States* 301 F.2d 200 (9th Cir.) (1962). A broker or commission agent generally falls in that category and therefore, specifically mentioned to be independent.

Broker, Commission agent - Meaning

Broker and commission agents are independent agents; broker, because his activity is only to bring parties together, and commission agent acts in his own name on behalf of a number of principals. A broker is an agent who acts as intermediary between buyer and seller of real or personal property or service, who does not take title to property in typical transaction but receives a fee ; and a commission agent is a person who performs services in connection with sales, purchases, collections, or other types of business transactions, and charges remuneration based upon a percentage of the amounts involved. (*see A Dictionary for Accountants* by Eric L. Kohler). The term "broker" is applied to those agents who by the custom of certain markets are entitled and recognized as being entitled to act for both purchaser and seller (Bankes L.J. in *Wilcock v. Pinto* [1924] 9 T.C. 129). The term "broker" was defined in a Canadian case, *Royal Securities Corp. Ltd. v. Montreal Trust* 59 DLR (2d) 666, as an agent employed to make bargains and contracts between other persons, in matters of trade, commerce or navigation, for a compensation, commonly called brokerage. A general commission agent does not in substance confine his activities to one principal but is ready to work for the clients generally (*see Fleming v. London Produce Co.* [1968] 44 TC 582 (UK). In that case, Megarry J. observed as follows, while concluding that the company was neither a broker nor a general commission agent :

"Third, the word 'general' in the phrase 'general commission agent' itself must have some import; and, in the context I think the most likely sense is that of a commission agent who holds himself out as being ready to work for clients generally, and who does not in substance confine his activities to one principal, or an insignificant number of principals. This, perhaps, is another facet of his broker- like qualities : he must be broker like in receipt of custom"

Paragraph 38.6 of the OECD Commentary also provides similarly.

An agent cannot be independent if he works exclusively or substantially for one principal, as observed the Australian Administrative Tribunal [(1993) 93 ATC 288] Broker or general commission agents are agents who represent, act for, and accounts to another. Thus, the distinction between brokers and commission agents on the one hand and other agents on the other is that they are independent agents who act for all seek their services and not bound to any one to the exclusion of others. For example, an advertising agent who was appointed as a sole advertisement representative of a foreign publisher, which also acted as agent for up to 19 other publications, was held to be an agent of independent status (*see Re Al Nisr Publishing* (1998) [239 ITR 879](#) (AAR)]. Their status as

independent agent is not affected if they regularly act for one principal and not for others, provided their services are also available for others.

Independent agents are of two types; general agent is one who initiates transaction in the name of the principal and carries on operations within a large discretionary area, a special agent is restricted to the performance of a single act or conduct of a single transaction. A general agent is one who is authorized to perform all of the acts of a special class or series, as opposed to a special agent who is empowered to perform only a particular act or to act upon some particular occasion [*see Donroy Ltd. v. United States* 301 F.2d 200 (9th Cir.) (1962)]. Agents of independent status, therefore, are those who acts on behalf of and in the name of the principal within a large discretionary area (*i.e.*, he is not subject to control in the area of his operation) which, however, do not extend to the power of negotiating the terms of contract.

Agent whether independent- consideration to be taken into account

An independent agent should be legally and economically independent (discussed in paragraph 11.24-4A). Besides, the following considerations should be borne in mind when determining whether an agent may be considered to be independent—

- ...◆An independent agent will be responsible to his principal for the results of his work but not subject to significant control with respect the manner in which that work is carried out or detailed instruction as to the conduct of the work. The principal relying on the special skill and knowledge of the agent is an indication of independence (OECD Commentary, article 5, paragraph 38.3)
- ...◆Dependency is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement and not by the limitations on the scale of business which may be conducted by him (Paragraph 38.4, OECD Commentary)
- ...◆Providing information to the principal in connection with the conduct of business is not a sign of dependence, but to ensure smooth running of the agreement. It, however, would be so if it is done in the course of seeking approval for the manner in which the business is to be conducted (Paragraph 38.5).
- ...◆Independent status is less likely if the activities are performed wholly or almost wholly on behalf of only one enterprise over the life time of the business or a long period of time. It is, however, to be seen whether the activities constitute an autonomous business conducted by the agent in which he bears risk and receives reward through the use of entrepreneurial skills and knowledge. Where an agent acts for a number of principals, legal dependence may exist if the principals (none being predominant in terms of the agent's) act in concert to control the acts of the agent business (paragraph 38.6).

From the above it could be said that independency is indicated if

- ...◆the agent has wide discretionary power and the principal not having extensive right to instruct the agent and to control business or impose sanctions upon the agent;
- ...◆the agent has large number of clients and not devoting all or almost all his time to one client ;
- ...◆the agent bears entrepreneurial risks and receives rewards through entrepreneurial skills and knowledge;
- ...◆the agent performs the activity which is within ordinary course of his business; not the activity which is unusual for himself or for particular industry unless proved to be done in an independent manner.

Independent agent-legally and economically independentIndependent agent-legally and economically independent

11.24-4A As an independent agent must satisfy two conditions:

- (1) The agent must be both legally and economically independent of the enterprise; and
- (2) He must be acting in the ordinary course of the business in carrying out activities on behalf of the enterprise.

As regards an agent being legally independent, he is not so regarded if he is subject to detailed instructions regarding the conduct of his operations or comprehensive control by the enterprise.

As regards economic independence, the relevant factor is the extent to which the agent bears the business risk. Business risk refers to primary risk of loss. Another factor is whether the agent has an exclusive or nearly exclusive relationship with the principal. Such a relationship may indicate that the principal has economic control over the agent. The limited scope of agent's activities and dependence on a single source of income may indicate lack of economic independence. That test, however, is not conclusive. Despite of exclusive relationship with the principal, he may have the capacity to diversify and acquire other clients without substantial modification to the current business and without substantial harm to its business profits. Exclusivity is only pointer of lacking independence and thus indicative of further investigation. Each case must be decided on its facts.

Independent Agent - In the Ordinary Course of Business

11.24-4B An otherwise independent agent is deemed dependent if while performing acts on behalf of the enterprise he is not acting in the ordinary course of his business. Paragraph 38.7 of the OECD Commentary explains "Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to their own business operations", and then illustrates, "Where for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect this particular activity to be permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of commission agent), unless the activities are limited to those mentioned at the end of paragraph 5 (activities of preparatory or auxiliary nature)". In *Secretary for Inland Revenue v. Downing* [1975 (4) South African Law Reports 518] a stockbroker who had complete autonomy as regards the taxpayer's investment portfolio was held to be an independent agent operating within the ordinary course of his business. In deciding, three criteria were emphasized:

- i. the fact that the appellant himself took no part whatever in the management of the portfolio;
- ii. the wide discretion and unqualified power of management ;
- iii. the degree of permanency to this discretion of power.

It is not the ordinary course of business of a commission agent to sell goods or merchandise in his own name and to act habitually as a permanent agent of a client with authority to conclude contracts. The test is similar to the test to determine dependency.

Another test which can be read from the said paragraph is whether the activity performed by the agent belongs to the sphere of the enterprise rather than to that of his own. If so, it falls outside the course of his business. In performing activity which is different from that of the agent, the agent cannot be said to be acting during the course of his business. The agent is considered dependent if his activity is the business of the principal. So that it is not so, it has to be carried out in "ordinary course of his business"

The third test depends on the interpretation of the expression "ordinary course of their business", whether it means the activity normally conducted by the agent or done normally in the line of business by other agents. The word "their" qualifying "business" does not answer the question. The expression "their business" could mean either way. It could mean the business particular to an agent and also the business in the specific line of his activity. The word "ordinary" means normal. Activity in an ordinary course of business is the activity which is normally or usually performed by persons engaged in a particular line of business. It is typical to the industry rather than typical for a particular agent. For example, an architect handling the advertising and sale of apartments does not fall within their ordinary course of profession of an architect. The test of "ordinary course of business" was applied by the UK High Court in *Fleming v. London Produce Co. Ltd.* [1968] 44 TC 582. The court considered the way the agent performed his business and found it lacked the generality of custom which characterised brokerage. The circumstance that the agent paid freight and marine insurance of the goods, although neither of these was connected with the sale of the goods, but with their procurement, was found uncharacteristic of brokerage. "Ordinary course of business" was related to the normal brokerage.

One should examine business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent, and not any other business activities, to see whether particular business activities fall within or outside the ordinary course of business of the agent (*see* OECD Commentary, article 5, paragraph

38.8). Persons performing activities which, economically, belong to the sphere of the enterprise rather than that of their own, cannot be said to be acting in the ordinary course of their business. For example, a commission agent not only selling goods or merchandise of the enterprise in his own name but also habitually acting as a permanent agent of the enterprise with the authority to conclude contract, would be deemed to be permanent establishment rather than an independent agent acting in the ordinary course of his business (*see* OECD Commentary, article 5, paragraph 38.7)

The OECD Commentary (paragraph 38.8) could similarly be interpreted. It reads "in deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one should examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other activities carried out by that agent. Whilst the comparison normally should be made with the activities customarily to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example, where the agent's activities do not relate to a common trade." Business activity customarily carried out within the agent's trade as agent may mean the activities he usually performs and also mean activities usually performed in his line of trade. The business activity of a specific agent is to be related to what is the general business conduct in the industry (BFH in B St BII 626, Insurance 1975 case) The German Supreme Court in Container case (BFH in BFHE Bd. 139 (1984) 411) held that compliance with the "ordinary course of business test" did not require all or a majority of the enterprises in the trade pursued the activity, the business activity may still be within the ordinary course of the agent's business if the activity is within the scope of the industry's activity in the future.

Permanent establishment - Agent, Services of Internet Service Provider (ISP)Permanent establishment - Agent, Services of Internet Service Provider (ISP)

11.24-5 The service provided by the Internet Service Provider (ISP) does not qualify for PE. The ISP is a company that provides access to the internet. For a monthly fee the service provider gives a software package, user name, pass word and access phone number. Equipped with modem, one can then log on to the internet and browse the World Wide Web and send and receive E-mail. ISPs themselves are connected to one another through Network Access Points (NAPs). The ISP merely acts as an intermediary between a non-resident seller and the customers in the source country. Therefore, the ISP does not qualify as an agent of the non-resident seller. Since the ISP acts on behalf of several website owners, even if it is treated as agent, it would be an independent agent and not a dependent agent. Therefore, it will not constitute a PE. Even if it acts for only one website owner, it does not have the authority to conclude contracts on behalf of the site owner, it does not have the authority to conclude contracts on behalf of the website owner.

Permanent establishment - Foreign Institutional Investor(FII)Permanent establishment - Foreign Institutional Investor(FII)

11.24-6 A Foreign Institutional Investor is an institution established or incorporated outside India which proposes to make investment in India in securities. It cannot buy, sell or otherwise deal in securities in India unless it holds a certificate granted by the Securities and Exchange Board of India (SEBI). One of the conditions for grant of the certificate is that it shall appoint a domestic custodian providing for custodial service in respect of the securities and enter into an arrangement with a designated bank for the purpose of operating a special non-resident rupee or foreign currency account. The domestic custodian acts as a custodian of securities for the FII. The FII shall ensure that the domestic custodian takes steps for-

- (a) monitoring of investments of the FII in India;
- (b) reporting to the Board (SEBI) on a daily basis the transactions entered into by the FII;
- (c) preservation for five years of records relating to its activities as FII ; and
- (d) furnishing such information to the Board as may be called for by the Board with regard to the activities of the FII and as may be relevant for the purpose of the SEBI (Foreign Institutional Investors) Regulations, 1995.

Every FII is required to appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications guidelines, instructions, etc., issued by the Board or the Central Government. It is also required to preserve the following books of account, records and documents for a minimum period of five years and also to intimate the Board where these are to be kept:

- (a) true and fair accounts relating to remittance of initial corpus for buying, selling and realizing capital gains of investment made from the corpus;
- (b) accounts of remittances to India for investments in India and realizing capital gains on investments made from such remittances;
- (c) bank statement of accounts ;
- (d) contract notes relating to purchase and sale of securities ; and
- (e) communication from and to the domestic custodian regarding investments in securities.

A question arises whether income arising from the purchase and sale of securities in India is to be categorized as income from business or capital gains; and in case of the former, whether the domestic custodian taken PE of the FII if it has been operating from the foreign country.

The matter was considered by the *Fidelity Adviser Series VII, In re* (2004) [271 ITR 1](#) (AAR). The Authority for Advance Rulings held that in view of the enormity and frequency of purchases and sales, the applicant held shares as stock-in-trade and the profits from the purchase and sale of shares were in the nature of business profits and that the business profits cannot be taxed in India in view of article 7 of the DTAA because it did not have a branch or office in India and therefore a PE and that the domestic custodian being not an independent agent as contemplated by article 5(5) of the DTAA could not also be considered PE.

The above findings are not free from doubts. On the Authority for Advance Ruling in the later case expressed the view that these are not based on full facts and legal issues involved (discussed infra)

While holding that the applicant had been doing business in securities, the Authority relied on the decisions of the Supreme Court in *Raja Bahadur Visheshwar Singh v. CIT* [1961] [41 ITR 685](#), *Dalhousie Investment Trust Co. Ltd. v. CIT* [1968] [68 ITR 486](#), and *CIT v. Sutlej Cotton Mills Agency Ltd.* [1975] [100 ITR 706](#). These decisions related to the Indian companies. Their relevance to FIIs whose recognition for operating in the security markets in India are regulated by the SEBI, is to be considered. It could not perhaps be the intention of the SEBI and the rules made by it that an FII carries on business in securities in India and repatriates profits without any tax obligation, in the circumstances of a case similar to the one before the Authority.

FII has been defined to mean an institution established or incorporated outside India which proposes to make investment in India in securities. Its investments in India are to be monitored. Records and accounts relating to investments made from the corpus remitted to India and from other remittances, realization of capital gains from such investments, exchange of communication with the custodian regarding investments are required to be preserved for five years. The emphasis is on "investments" and "capital gains" and not on "business" and "profits". In order to constitute an investment, the amount laid down should be capable of and resulting in any income, return of profit to the investor. In every case of investment, the intention and positive act on the part of the investor should be to earn such income, returns, profit. In order to constitute an investment, the moneys should be laid out in such a manner as to acquire some specie of property which would bring an income to the investor (*see DIT v. Alarippu* [2000] [244 ITR 358](#) (Delhi)). Every mode of application of one's money intended to yield a return by way of interest, income or profit is investment [*see CIT v. Calcutta National Bank Ltd.* [1959] [37 ITR 171](#) (SC)]. Investments by the FII are made from the corpus and other remittances.

The FII purchases the securities not as stock-in-trade but as a specie of property which would bring income to it by way of dividend or profits and gains on their sale. If an asset is employed by way of investment and produces income, the income arises or springs from the asset. The operation which causes the income to spring is the operation of investment. In the operation of investment, income is produced while assets continues to belong to the assessee. Profit arises from the sale of the asset. In the operation of sale, gain is produced, which is still income, but in the process, the title to the asset is parted with. Although the process involved in the two cases are different, the gain which has resulted to the owner of the asset, in each case, is the gain which has sprung or arisen from the asset. The source of income is the property held as investment, as dividends and capital gains and not the activity of carrying on business in dealings with securities holding them to be as stock-in-trade. The enormity and frequency of transactions of investment would not change the character of investment and the nature of income arising from securities held as a specie of property yielding income by way of dividend or by way of gain.

Even if, for argument sake, the FII be taken doing business in shares, the domestic custodian may be taken its PE. The authority held it not to be, on the ground that the custodian was an agent of the FII, though independent as

contemplated by article 5(5) of the DTAA. Domestic custodian has to be statutorily appointed as a condition for the grant of a certificate by the SEBI to enable an FII to deal in securities in India.

A custodian of securities is a person who carries on the business of providing custodial services for safekeeping and services incidental thereto including maintaining accounts of securities of a client, collecting the benefits or rights accruing to the client, keeping the client informed of the actions taken or to be taken by the issuer of the securities etc. Custodians of securities are an integral part the securities market and have an important role to play in the institutional segment of the market. Their role is crucial in the effective functioning of the securities clearing and settlement system. They are governed by the SEBI (Custodian of Securities) Regulations, 1996 and not by the contractual agreement with a client appointing a domestic custodian in respect of securities. That agreement only provides the circumstances under which the custodian will accept or released securities or money from the custody account, or receive rights or entitlements, the circumstances and the manner of registration of securities etc. They are responsible and accountable to the Board as well as the client. A domestic custodian cannot be said to be an agent in the sense of article 5(5) of the DTAA. Even if so taken, it is not an agent of independent character, because it is subject to detailed instructions regarding the conduct of its operations and also does not bear the primary business risk of loss. It undertakes all activities of the FII as regards securities; such as clearing and settlements accepting or releasing securities or money, receiving rights or entitlements on the securities, registering securities etc. In fact the custodian manages the securities on behalf of the FII. It could be said to be its "office" or the "place of management:" and PE in terms of para 2 of article 5 of the DTAA. The custodian has the authority to carry on some part of the FII's money making activities, and is, thus, *i.e.* PE.

Authority for Advance Ruling in a subsequent case, *Fidelity Northstar Fund, In re* [2007] [158 Taxman 372](#) (AAR - New Delhi), however, observed that its ruling in the *Fidelity Adviser Series VIII, USA, (supra)* [2005] [272 ITR 416](#) (AAR- New Delhi) and in some of the other cases full facts and legal issues involved were not brought to the notice of the Authority, and that regardless of volume or frequency of transactions the investment in securities by FII shall be as capital investments giving rise to capital gains, as was reflected in the ruling in *Universities Superannuation Scheme Ltd., In re* [2005] [275 ITR 434](#) (AAR- New Delhi).

Permanent establishment - Subsidiary CompanyPermanent establishment - Subsidiary Company

11.25 Paragraph 8 of the UN Model Convention (paragraph 7 of the OECD Model) provides that the fact that a company which is resident of a Contracting State—

- ...◆controls or is controlled by a company which is resident of another Contracting State, or
 - ...◆which carries on business in that other State (whether through permanent establishment or otherwise)
- shall not by itself constitute either company a permanent establishment of the other.

A subsidiary company is a legal entity separate from the parent company and the business carried on by it is its business and not of the parent company. A corporation is a separate taxable entity even if it only has one shareholder (*see Moline Properties Inc. v. Comm'r* 319 US 436 [1948]). A subsidiary would, however, be parent's PE, like any other entity, if it is a fixed place of business in terms of article 5(1) or acts as its agent in terms of article 5(5).

Whether a related company constitutes PE, the factors to be taken into consideration are those mentioned in paragraphs 1 through 7 (6 of the OECD Model) and not solely by the fact that one company controls or is controlled by another. Ownership or control relationship does not decide as does the existence of circumstances set out in paragraph 1 subject to paragraphs 3 and 4 or set out in paragraph 5 subject to paragraph 6 of the OECD Model. The fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company. (*see* OECD Commentary, article 5, paragraph 40) ; or the fact that the parent's ownership of the capital of the subsidiary does not make it dependent upon the parent company (*see* OECD Commentary, paragraph 38.1) The subsidiary company would constitute a PE under the basic rule under paragraph 1 of article 5 subject to paragraphs 3 and 4 or under the agency clause of paragraph 5 [*see* OECD Commentary, article 5, paragraph 41). Any space or premises belonging to the subsidiary at the disposal of the parent company meets the requirement of paragraph 1, a fixed place through which the business is done. PE agency requirement of paragraph 5 is met if the subsidiary has and habitually exercises the authority to conclude contract in the name of the parent company and does not act in the

ordinary course of its business as independent agent. In both situations, however, the activity should not be of preparatory or auxiliary character.

To be a basic rule PE, construction PE or the agency PE, the subsidiary company must satisfy the criteria set out in the provisions of the concerned paragraphs as 1 and 2 (basic rule); 3 (construction PE), 5 and 6 of the OECD Model (Agency PE), subject to paragraph 4. Where the core business activities are conducted through the subsidiary's premises or through its agency (dependent, or independent where the subsidiary acting outside the ordinary course of its business), a PE is constituted.

Article 5(1) requires a place of business at the disposal of an enterprise. This rule also applies in case of subsidiary company, with only exception that the place of business does not include place of management. A subsidiary is not a PE even if its business is managed by the parent company (*see* OECD Commentary, article 5, paragraph 40).

It is the exercise, or the power to exercise, of control which determines whether the company over which such power is exercised is the subsidiary of the company exercising it. To control means to exercise power over the functioning and policy. It means possession, direct or indirect, of the power to direct or cause the direction of management and policies of the company whether through ownership of the voting securities, or having power to choose at best a majority of members of the board of directors. Management means administration, control etc., of an enterprise (*Ghanshyamdas Badrilal v. State of Madhya Pradesh* AIR 1969 MP 186). The management and policies for the purposes of controlling the company refer to the company itself, *i.e.*, controlling the company through the power of controlling the composition of its board of directors, and not to the actual conduct of business transactions and business activities. Shareholder's controlling of a company does not amount to "management" in terms of the PE definition of a treaty [*see* Hoge Raad in BNB (1987/306)]. The parent company's activity as a "place of management" of the subsidiary is not sufficient for a PE. [*see Conseil d'Etat* of October 2 1985 in (1985) 37 *Droit Fiscal* 50, p.2192 discussed in (1986) E.T.118]. Thus, control or supervision does not decide whether a subsidiary is the PE of the parent company.

If the subsidiary company is the alter ego of the parent company (*i.e.*, it merely performs the business of the parent company), then the PE would result but not if it is legally independent and performing a viable business activity (*see* IRS in Letter Ruling 79-18-105 and Letter Ruling 79-23-075).

Subsidiary may sometimes be used as facade for the parent company with no or little resources for carrying through the contract entered into in its name, the parent company supplying the resources "on hire" or completing the assignment as a sub-contractor. The parent company performs the work entirely or substantially by involving itself as a sub-contractor or letting the use of its resources (employees, machinery, know-how, financial capital). The intention of the subsidiary from the beginning is to pass over the contract for the parent company to perform. The contract is concluded by the parent company as if done directly, or done as a joint-venture (the parent company) providing extensive co-operation through necessary equipment, know-how and financial capital. Even under these circumstances no PE may be constituted, if it could be shown that the subsidiary company has not been authorised to conclude contract which is the basic requirement of an agency PE. It may constitute, if the subsidiary and the parent companies both are performing on the same project which in terms of paragraph 18 of the OECD Commentary "be regarded as a single unit, even if based on several contracts..... (to form) a coherent whole commercially and geographically"

Action on behalf of a foreign enterprise is not sufficient to hold a person permanent establishment, unless the agency exists as an organisation identifiable as the 'locus' of operations, something physical and separately identifiable as the place of business belonging to the non-resident enterprise. For an enterprise to trade in a foreign country by way of a permanent establishment, the agent must fill orders on behalf of the enterprise from stock of goods. If the 'agency' trades on its own behalf, and not that of the foreign enterprise in the sense that it exercise an authority to conclude contracts in the name of the foreign enterprise, it is not the permanent establishment.

Similarly, mere existence of a sale representative in a foreign country is not permanent establishment, unless it has authority to conclude contracts on behalf of the enterprise or to fill up orders on its behalf from a stock of goods - *Ronson Art Metal Works (Canada) Ltd. v. Minister of National Revenue* 10 DTC 440 and *American Wheelabrator & Equipment Corp. v. MNR* 51 DTC 285. However, where the sales organisation is elaborate with full authority to contract and accept orders on behalf of foreign enterprise, there arises a permanent establishment - *Panther Oil & Grease Mfg. Co. of Canada v. MNR* 11 DTC 494.

Permanent establishment - Subsidiary and parent company - principal-to-principal transactions

11.25-1 A question arises whether the dealings between a non-resident parent company and its subsidiary can at all be regarded as on principal-to-principal basis since the former would be in a position to exercise control over the affairs of the latter. In such a case if the transactions are actually on a principal-to-principal basis and at arm's length and the subsidiary company functions and carries on business of its own, instead of functioning as an agent of the parent company, the mere fact that the company is a subsidiary of the non-resident company is not a valid ground for holding it to be a permanent establishment of the parent company. The Supreme Court in *DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#), held that the Indian company could not be regarded agency PE of the parent US company and the transactions between the two was at arm's length. The Indian company was remunerated at arm's length basis taking its account all the risk taking functions performed and risk assumed by it.

The mere existence of a 'business connection' arising out of the parent-subsidiary relationship will not give rise to an assessment, nor will the fact that the parent company might exercise control over the affairs of the subsidiary company - CBDT's Circular No. 23 of 1969. Thus, if in pursuant to indents placed by say the Indian subsidiary which are accepted outside India and the contracts are also executed outside India by putting goods on ships and there being no reservation of right of disposal of goods by the non-resident these products are not merely supplied by the non-resident company to the Indian subsidiary but are actually sold to the Indian subsidiary at certain prices. What is charged by the non-resident to the Indian subsidiary is the price and the transactions are not of the nature that there is supply of goods by the non-resident company to its Indian subsidiary on the basis of any commission or otherwise or for any other similar consideration. The transactions are as between principal-to-principal and not as between principal and agent Indian subsidiary and thus cannot be regarded affecting the sales as an agent of the non-resident company - *CIT v. Gulf Oil (Great Britain) Ltd.* [1977] [108 ITR 874](#) (Bom.).

The Supreme Court of Belgium (judgment of the Supreme Court of Belgium on French-Belgium Treaty) has held that a Belgian subsidiary of a French parent company was not the parents' 'permanent establishment', notwithstanding the very light control exercised by the parent company over the sales territory and product lines allocated to the subsidiaries notwithstanding the considerable amount of management and financial reporting which was required of the subsidiary. This decision of the Belgium Supreme Court, if regarded as persuasive in other countries, is of immense relief of multinational corporations (MNCs), which often do lay strict guidelines for the operations of their subsidiaries - *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP).

Thus, as a rule subsidiary company is not the PE of the parent company. But when it acts as an agent in the circumstances pointing to the parent company trading through its agency, it is to be so taken - *Firestone Tyre & Co. Ltd. v. Lewell* 37 TC 111 (HL). The mere use of the parent's company space and employees would not be enough. In *Tara Exploration & Development Co. Ltd. v. M.N.R.* 24 DTC 6370, the appellant parent company resident in Ireland had an arrangement with a related company in Ontario for the use of space and services of its employees. The parent company made profits from the sale of some shares. It had a bank account in Ontario for payments and receipts. The question was whether it had a PE in Ontario. Jactett P., concluded that a parent company had a "permanent arrangement" because the PE with the related company, but not the "permanent establishment" because the PE required "persons with authority to carry on some part of the taxpayer's money making activities". The related company was an agency in Canada.

The determination whether a permanent establishment exists is made solely on the basis of the factors described in paragraph 7 of Article 5. Whether a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

Permanent establishment - Group of companies

11.25-2 A question may arise whether a subsidiary company would be a PE of all members of a group of companies if it is a PE for one of them. Paragraph 41.1 of the OECD Commentary provides an answer. It says "The determination of the existence of a permanent establishment under the rules of paragraph 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State." This, however, may be distinguished from a situation where one member provides services (e.g., management services) to another member as a part of its own business carried on in premises that are not those of that other member company and using its own personnel. In that case,

the place of business cannot be considered to be the PE of the company to which the services are provided (*see* OECD Commentary, article 5, paragraph 42). The Commentary further provides that a company cannot be said to be carrying on business activity through a location simply because it is economically benefited by the business activity of another company carried on (by that another company) through that location. The commentary illustrates by an example: a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

It could, thus be seen that :

- ...◆Determination of the existence of permanent establishment be done separately for each company of the group;
- ...◆Provision of services (*e.g.*, management services) as an independent business activity from a location to another company of the group does not make that location the permanent establishment of the company;
- ...◆Driving economic benefit from the business activity of another company in another country does not mean that it has a permanent establishment in that country.

The above propositions meet the basis on which a PE is held by the Italian Supreme Court in *Department of the Ministry of Finance v. Philip Morris Germany GmbH* [[2002] 4 I.T.L.R. 903]. The Court held that an Italian group company - *Intertaba* - could be deemed PE of the German company and remitted to the lower court to decide the question. The German company had a contract to supply cigarettes to the Italian state monopoly, and nominated *Intertaba* to supervise warehouses and sales outlet in Italy. The Court held that *Intertaba* could be deemed as PE on, *inter alia*, the following that—

- ...◆*Intertaba* might have been acting as a multiple permanent establishment of several foreign companies;
- ...◆Its staff participated in contract negotiations and management of the business in Italy.

The existence of in a State of a PE would not by itself make it a PE of the other group companies. Similarly, a subsidiary of a foreign company having normal business relation with the branch of that foreign company, both situated in the same country, does not make the subsidiary as PE of the foreign company.

Permanent establishment - And E-businessPermanent establishment - And E-business

11.26 The concept of e-business, the place where contracts are made or performed, where income arising and whether income is taken to be as arising from carrying on business activity or from rendering services or be taken as royalties all have been discussed in detail in paras 1.20 to 1.26-4. Technological progress in the field of communication has considerably changed the manner of doing business, as discussed in Chapter 2. It affects the basic concepts of fiscal policies relating to cross-border transactions. Old concepts of geographical boundaries have been demolished. It is now a border-less world. Internet business, known as E-business could take place far from customers. The need of the persons to a transaction, or the middleman, present physically has been eliminated. The basic rule of the PE *i.e.*, the fixed place of business and the agency - rule PE are crumbling. E-business does not recognise either. It does not fit in the traditional concept of PE. None of its tools could be taken as representing business presence in the foreign country, on the basis of the criteria as laid out in the definition of PE. There is a view that Server does not qualify as PE. It maintains a database of pictures and softwares to download when so ordered by a client. It is space on the computer disk. It does not constitute physical presence. It is a base with no other form of business. It is also not fixed. It is easily movable. It is also not a branch or office. It is not a machinery or equipment as it is essentially a disc space. It is not an agent also. Website is also not a PE. It cannot constitute a place of business. A customer's computer terminal cannot be regarded as PE of a foreign enterprise of which that enterprise could not possibly be aware of PE cannot be established the world over without the participation or even the knowledge of the enterprise in another country. The only determinant which could be ascertained is the residence of the seller. E-business is, therefore, heading towards the residence base taxation. In that context, the PE concept appears irrelevant. But the apparent is not real. E-business could deal in digital goods and not other goods or services. PE is very much relevant to the cross-border transactions relating to the latter.

The flow of "goods or services" in E-commerce relate to products or services which are "technological" in nature. Questions, therefore, arise (1) in what way income from cross-border transfer of technological goods or services treated differently than income generated from the supply of other forms of products or services, (2) how transfers are distinguished if different forms of transfer are subject to different taxation rules. Different taxation regime is applicable depending upon how the technology transfer is treated, whether as sales income, royalties, income from

the supply of technology-related services, business profits, technology accompanied by the transfer of tangible property. All these issues are discussed later. Presently, what is required to be considered is whether the transfer could be taken as business profit and how far the present concept of PE is relevant and whether "goods or merchandise" are different from the "technological goods" or "digitised goods".

Permanent establishment - Goods or services and digital goods

11.27 A reading of article 5 suggests that the focus of the PE is on material and tangible goods having physical form and shape, and not on the digital goods which could be represented in zeros and ones. Sub-paragraph 4 refers to goods or merchandise. Such goods and merchandise cannot be delivered through internet. Services referred to in sub-paragraph 3(b) are also material; otherwise the expression "furnishing" would have not been used. Intangibles cannot be furnished, in the manner as material things could be done, unless the said intangibles have some relation with materiality. Display of goods on website, though could be said as representing warehouse, cannot be taken qualifying as PE in view of paragraph 5(4)(b).

Permanent establishment - Goods and merchandise - Meaning

11.28 "Goods and merchandise" mean generality of goods and are subject to trade. As is commonly understood "goods" necessarily mean things or articles which we enjoy with our physical sense of touch, sight, taste, hearing or smell and which are capable of movement from place to place. All eatables, musical instruments, reproductions, perfumes which satisfy our senses of sight, taste or hearing are goods.

"Goods" has been defined in Sales Tax Act of States to mean all kinds of movable property except actionable claims, stocks, shares and securities. It includes all materials, articles and commodities, which have been used in the same sense as used in article 366(12) of the Constitution of India. It, therefore, includes even incorporeal and/or intangible properties. The Supreme Court in *Tata Consultancy Services v. State of Andhra Pradesh* [2004] 271 ITR 401 observed :

"In India the test, to determine whether a property is "goods", for the purposes of sales tax, is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed, etc."

It also observed:

"What is essential for an article to become goods is its marketability."

In the case of *State of A. P. v. National Thermal Power Corporation Ltd.* [2002] 5 SCC 203; [2002] 127 STC 280, the question was whether electricity was goods. The Supreme Court held that the definition of "goods" in article 366(12) of the Constitution of India was very wide and included all kinds of movable properties. It was held that the term "movable property" when considered with reference to "goods" as defined for the purpose of sales tax cannot be taken in a narrow sense. It was held that merely because electric energy was not tangible or would not be moved or touched like, for instance, a piece of wood or a book it would not cease to be movable property when it had all the attributes of such property. It was held that electricity was capable of abstraction, consumption and use which, if done dishonestly, was punishable under section 39 of the Indian Electricity Act. It was held that electric energy could be transmitted, transferred, delivered, stored and possessed in the same way as any other movable property. It was held that electricity was thus "goods" within the meaning of the Sales Tax Act.

The three major attributes of a good are:—

1. It should be capable of being experienced by human sense of faculties of touch, sight, hearing, taste and smell;
2. It should be object of transaction, involving transfer;
3. It should be under the domain of the enjoyer.

It is not necessary that for the said attributes, the article should be corporeal having form and shape. The said concept extends to include some incorporeal and intangible rights, capable of being possessed, bought and sold. The Supreme Court so held in *H. Anraj v. Government of Tamil Nadu* [1986] 61 STC 165, in the context of a lottery ticket. The lottery ticket confers two rights on purchase; one, a right to participate in the draw; and, the second, a right to claim prize. The latter is an actionable claim; while the former constitutes beneficial interest in

movable property (incorporeal in character) in the holder of the ticket. It is, therefore, goods capable of being possessed and bought or sold.

A "goods" may be a tangible property or an intangible one. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) capable of being bought and sold ; and (c) capable of being transmitted, transferred, delivered, stored and possessed (*see Tata Consultancy Services v. State of Andhra Pradesh (supra)*, at page 432, as per Justice S. B. Sinha)

The Supreme Court in *Tata Consultancy Services v. State of Andhra Pradesh* [2004] 271 ITR 401 observed that the test to determine whether the property is tangible or intangible or incorporated, but is whether the concerned item is capable of abstruption, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed etc.

Permanent establishment - Goods or merchandise, whether intellectual property

11.28-1 Goods is every kind of movable property other than actionable claim or money. Clearly movable property is used in contradistinction with immovable property and actionable claim. On the same analogy intellectual property such as patents, trade mark, and copyrights constitute beneficial interest in movable property (incorporeal in character) in the possession of the holder of the rights therein. These are capable of being possessed, bought and sold.

In *Associated Cement Companies Ltd. v. CC* [2001] 4 SCC 593; [2001] 124 STC 59, a question arose whether customs duty was leviable on technical material supplied in the form of drawings, manuals and computer disc, etc. It was, *inter alia*, argued that that customs duty could not be levied as the drawings, designs, diskettes, etc. were not goods and that they only constituted ideas. It had been submitted that what was being transferred was technology, *i.e.*, the knowledge or know-how and thus, even though this may be valuable, it was intangible property and not goods. Under the Customs Act any kind of movable property constituted goods. The Court observed that any media whether in the form of books or computer disks or cassettes which contain information technology or ideas would necessarily be regarded as goods and that intellectual property when put on a media would be regarded as an article on the total value of which customs duty was payable. It also observed:

"33. It is true that what the appellants had wanted was technical advice on information technology. Payment was to be made for this intangible asset. But the moment the information or advice is put on a media, whether paper or diskettes or any other thing, then what is supplied becomes a chattel. It is in respect of the drawings, designs, etc., which are received that payment is made to the foreign collaborators. It is these papers or diskettes etc. containing the technological advice, which are paid for and used. The foreign collaborators part with them in lieu of money. It is, therefore, sold by them as chattel for use by the Indian importer. The drawings, designs, manuals, etc., so received are goods on which customs duty could be levied.

44. It is a misconception to contend that what is being taxed is intellectual input. What is being taxed under the Customs Act read with the Customs Tariff Act and the Customs Valuation Rules is not the input alone but goods whose value has been enhanced by the said inputs. The final product at the time of import is either the magazine or the encyclopaedia or the engineering drawings as the case may be. There is no scope for splitting the engineering drawings or the encyclopaedia into the intellectual input on the one hand and the paper on which it is scribed on the other. For example, paintings are also to be taxed. Valuable paintings are worth millions. A painting or a portrait may be specially commissioned or an article may be tailor-made. This aspect is irrelevant since what is taxed is the final product as defined and it will be an absurdity to contend that the value for the purposes of duty ought to be the cost of the canvas and the oil paint even though the composite product, *i.e.*, the painting, is worth millions.

An intellectual property, once it is put on a media, whether it be in the form of a book or canvas (as in case of painting) or computer discs or cassettes, and marketed would become "goods" [*see Tata Consultancy Services v. State of Andhra Pradesh* [2004] 271 ITR 401 (SC)]. The Supreme Court in that case observed :

"We see no difference between a sale of a software programme on a CD/floppy disc from a sale of a music on a cassette/CD or a sale of a film on a video cassette. In all such cases, the intellectual property has been incorporated on a media for purposes of transfer. Sale is not just of the media which by itself has very little value. The software and the media cannot be split. What the buyer purchases and pays for is not the disc or the

CD. As in the case of paintings or books or music or films the buyer is purchasing the intellectual property and not the media, *i.e.*, the paper or cassette or disc or CD."

But while dealing with the assessable value of the computer for the purpose of excise duty, it is held by the Supreme Court in *PSI Data Systems Ltd. v. CCE* (1997) 2 SCC 78 that a computer and its software are distinct and separate and both as a matter of commercial parlance and also upon the material on record.

The documents embodying the patents are goods. Thus, where a resident in a country A grants in that country the right in the country B to exercise intellectual property rights which he has acquired by registration or application, he does not render a service in country B by the grant. Nor does he render service in the country B or anywhere else by refraining in consequence of the grant from taking preventive action against the grantee. Rendering a service connotes some positive action on the part of the renderer and not a state of passivity, for example, oversight by an engineer of a civil engineering project in another country. Thus if a company hires out equipment for a given time on payment of fixed fee, its profit is derived from the contract of hire and not for its continued forbearance from seeking to recover that equipment during the contract period. Similarly, if a company grants rights in an intellectual property for a given time on payment of a fixed fee, it could be said to be deriving profit from carrying on business. The company has no financial interest in the subsequent exercise of the rights by the grantee.

The American courts [*South Central Bell Telephone Co. v. Sidney J. Barthelemy* (643 So. 2d 1240); *Comptroller of the Treasury v. Equitable Trust Company* (464 A.2d 248); *Chittenden Trust Co. v. Commissioner of Taxes* (464 A.2d 1100); *University Computing Company v. Commissioner of Revenue for the State of Tennessee* (677 S.W. 2d 445) and *Hasbro Industries, Inc. John H. Norberg, Tax Administrator* (487 A.2d 124)], held that when stored on magnetic tape, disc or computer chip, the software or set of instructions is physically manifested in machine readable form by arranging electrons, by use of an electric current, to create either a magnetized or unmagnetized pace. The machine readable language or code is the physical manifestation of the information in binary form. It has been noticed that at least three program copies exist in a software transaction (*i*) an original, (*ii*) a duplicate, and (*iii*) the buyer's final copy on a memory device. It has been noticed that the program is developed in the seller's computer then the seller duplicates the program copy on software and transports the duplicates to the buyer's computer. The duplicate is read into the buyer's computer and copied on a memory device. It has been held :

- that the software is not merely knowledge, but rather is knowledge recorded in a physical form having a physical existence, taking up space on a tape, disc or hard drive, making physical things happen and can be perceived by the senses;
- that the purchaser does not receive mere knowledge but receives an arrangement of matter which makes his or her computer perform a desired function;
- that the arrangement of matter recorded on tangible medium constitutes a corporeal body;
- that a software recorded in a physical form becomes inextricably intertwined with, or part and parcel of the corporate object upon which it is recorded, be that a disc, tape, hard drive, or other device;
- that the fact that the information can be transferred and then physically recorded on another medium does not make computer software any different from any other tape of recorded information that can be transferred to another medium such as film, video tape, audio tapes or books;
- that by sale of the software programme the incorporeal right to the software is not transferred ;
- that incorporeal right to software is the copyright which remains with the originator. What is sold is a copy of the software;
- that the original copyright version is not the one which operates the computer of the customer but the physical copy of that software has been transferred to the buyer;
- that when one buys a copy of a copyrighted novel in a bookstore or a recording of a copyrighted song in a record store, one only acquires ownership of that particular copy of the novel or song but not the intellectual property in the novel or song.

Permanent establishment - Digital goods are not goods or merchandise but product of different nature

11.28-2 The concept of PE as defined in article 5 of the OECD/UN Model is relevant only to goods and merchandise which are things or articles which we enjoy with our physical sense or which are capable of

movement from one place to another. Such articles cannot be on loaded or down loaded through internet. The E-business could deal with only digital goods, such as software, electronic media, and information. Such goods lack materiality, shape and form. These could be represented in zeros and ones, in the language which the computer understands.

Goods and intellectual product - Distinction

For the production of an intellectual product, input required is the data, knowledge or skill, which is intellectually processed into final product information or solution which could be delivered through internet by downloading. The nature of the input and the output differs from the manufacturing which deals with material input and output. On the input side, in the one case it is the intellectual processing of knowledge and skill of the workers while in the other, manufacturing of the raw material. On the output side, it is respectively the service and tangible goods. The essential fact remains the same in the creation of product and services, *i.e.*, employment of capital and labour. The mode of delivery of tangible goods and of services differ. The difference between the nature of input, output and mode of delivery does not affect the concept of PE. The intangibles, such ideas, plans, procedure, formulas, etc. are the product of an intellectual process, as music is the product of the artistry of the musicians which in itself is not goods. But when transferred to a laser- readable disc, they become a readily merchantable commodity. The disc is a tangible goods and could be physically delivered. The intangibles could also be delivered to the customer by downloading directly to the hard disc of his computer. In one the mode of delivery is physical, whereas in the other it is digital. The essence of the transaction is the sale of intangible information or music. In order to make a physical delivery, the information is required to be transformed or converted into a different state or form. Such transformation or conversion is not ‘ manufacturing’ because no ‘ material or thing’ has been transformed or converted. The disc may be tangible, but the information is intangible. That information could be made directly available to the customer by having him downloaded for a consideration. The purpose in both cases is transfer and deliver the ‘ information’. The mode of delivery does not effect the nature of the transaction, *i.e.*, the sale of a product. The consideration is paid for the purchase of the product, which does in no manner result in the transfer of a copyright in the product. The consideration is paid for the use of the product and not for any right in respect of copyright or in the patent, model, design or secret formula or in trade mark or in similar property. The income arising from the transaction is therefore assessable as business profit and not as royalty.

Intellectual property - Goods

An intangible property may become goods, if it has attributes of thereof having regard to—

- its utility;
- capable of being bought and sold; and
- capable of being transmitted, transferred, delivered, stored and possessed.

If a software, whether customized or non-customized satisfies these attributes, the same would be goods. The courts in India have not gone into the question of severability. A canned software normally satisfies the above attributes and, thus, is regarded goods. But Justice S. B. Sinha observed as follows in *Tata Consultancy Services v. State of Andhra Pradesh* [2004] 271 ITR 401 (SC):

"A software may be intellectual property but such personal intellectual property contained in a medium is bought and sold. It is an article of value. It is sold in various forms like floppies, disks, CD-ROMs, punch cards, magnetic tapes, etc. Each one of the mediums in which the intellectual property is contained is a marketable commodity. They are visible to senses. They may be a medium through which the intellectual property is transferred but for the purpose of determining the question as regards leviability of the tax under a fiscal statute, it may not make a difference. A programme containing instructions in computer language is subject-matter of licence. It has its value to the buyer. It is useful to the person who intends to use the hardware, *viz.*, the computer in an effective manner so as to enable him to obtain the desired results. It undisputably becomes an object of trade and commerce. These mediums containing the intellectual property are not only easily available in the market for a price but are circulated as a commodity in the market. Only because an instruction manual designed to instruct use and installation of the supplier programme is supplied with the software, the same would not necessarily mean that it would cease to be "goods". Such instructions contained in the manual are supplied with several other goods including electronic ones. What is essential for an article to be become goods is its marketability."

The courts have held that the software programme when put on a medium becomes goods, for the purpose of sales tax (*see Tata Consultancy case*), or customs duty (*see Associated Cement Companies' case*), because the expression "goods" has been defined in a widest term. Every kind of movable property is considered goods. The test for the purpose is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use and whether it is can be transmitted, transferred, delivered, stored, possessed, etc.

The matter is discussed in detail in the following paragraphs.

Permanent establishment - Software - Whether goods or services

11.28-3 Software is goods as well as services, as already discussed. It is goods, if standardised and off-the-shelf item. It is services if customised or tailor-made. In case of the former, the transaction is the sale of goods; while in the latter, rendition of services. Software may be sold like manufactured products bundled in CD. Internet has made it possible to sell it as services. Many software majors (*e.g.*, IBM, Sun, Red Hat, Trend Micro) are now offering their products as services and asking consumers to pay service charges rather than one-time licence fees. Many other software vendors are experimenting with the concept of delivering "services" through internet and doing away with software installation at the consumer end and thus shifting from upfront licence revenue to long-term subscription. Companies are looking to access software functionality as a service with a usage-based pricing, which could be compared to the pricing of utilities and infrastructure services such as telecom, real estate or transport. IBM India has recently launched Software as Services (SaaS), which provides remote access to business software as service.

A software package off the shelf is also called "canned" software, and a custom-made, as "uncanned". A canned software means "that is not specifically created for a particular customer. The sale or lease of, or getting a licence to use, canned software is not automatic data processing and computer services, but is the sale of tangible personal property. When a vendor, in a single transaction, sells canned software that has been modified or customised for that particular customer, the transaction will be considered the sale of tangible personal property if the charge for the modification constitutes no more than half of the price of the sale." After quoting this, Justice S. B. Sinha said in *Tata Consultancy Services v. Government of Andhra Pradesh* [2004] [271 ITR 401](#), "The software marketed by the appellants herein indisputably is canned software and, thus, as would appear from the discussions made hereinbefore, would be exigible to sales tax." The learned judge further said, "If a canned software otherwise is "goods", the court cannot say it is not because it is an intellectual property." (page 423)

Computer software means any computer programme recorded on any disc, tape, perforated media or other information storage device which is transmitted from one place to another by any means. Computer programme means a set of instructions as passed in words, codes, schemes, or in any other form including a machine readable medium capable of causing a computer to perform a particular task or achieve a particular purpose. It is considered a literary work and is legally protected under the Copyright law. Such programme becomes computer software when it is recorded in the manner as suggested above. Basically, it is a programme. It is recorded for communication. The media on which the programme is recorded represents the computer software. It is thus a commodity transferable and exportable. The consideration for such transfer or export is not the consideration for the use of any copyright but is the consideration for the transfer of information contained on the disc or any other media. The transaction has three components:—

- ...◆Sale of media;
- ...◆Supply of knowledge - what is on the media;
- ...◆After-sale service.

The sale of media is simply the sale of goods *i.e.*, the tangible property, being the plastic or magnetic tape. It has very little value. The sale of knowledge and after-sale service represent the intangible property. These two components by far represent the most significant part of the consideration. Major portion say ninety per cent of the value of recorded software is intellectual property. Only ten per cent, is the value of the material of which the information storage device is made. In case of a book, it is the reverse; ninety per cent is the cost of material and ten per cent, royalty. Whether income derived is from trading or as royalty, the question requires determination of

the dominant factor. If the dominant element is the intellectual skill involved in developing a programme, the entire profit could be said as having been derived as royalty. If sold as a product as an off-the-shelf item the profit is business profit. Thus, if the source of income consists substantially the development of a programme, the income is royalty and if substantially trading, the income is business income. In case of the development of a programme, the dominant effect on the taxpayer's profit is the intellectual skill, the source is not business, but know-how and the services.

Product or Intellectual property transfer-purpose for which consideration paid decides

What is required to be identified is the purpose for which the consideration is paid; whether for the purchase of a product or transfer of intellectual property *per se*. For example, in the case of purchase of book, the consideration paid is for a book and not for the underlying copyright. Copyright is incidental to predominant transaction of sale. The income is business and not royalty income. Thus, when the underlying intellectual property right is only incidental to the primary transaction, income cannot be regarded as royalty income. The Madras High Court in *CIT v. Neyveli Lignite Corporation Ltd.* [2000] [243 ITR 459](#) (Mad.) observed:

"In a contract for the design, manufacture, supply, erection and commissioning of machinery which does not involve licence of the patent concerning the machinery, or copyright of its design, mere supply of drawings before the manufacture is commenced to ensure that the buyer's requirements are fully taken care of and the supply of the diagram and other details to enable the buyer to operate the machines, and also to assure the buyer, that the machines will perform to the specification required by the buyer, such supply is only incidental to the performances of the total contract which includes design, manufacture and supply of the machinery.

The price paid by the assessee to the supplier is a total contract price which covers all the stages involved in the supply of machinery from the stage of design to the stage of commissioning. The design supplied is not to enable the assessee to commence the manufacture of the machinery itself with the aid of such design. The limited purpose of the design and drawings is only to secure the consent of the assessee for the manner in which the machine is to be designed and manufactured, as it was meant to meet the special design requirements of the buyer."

In *Modern Threads (India) Ltd. v. Dy. CIT* [2000] 243 ITR 60 (Raj.), the Rajasthan High Court held that the payment for the supply of Basic Process Engineering Documentation for designing, construction and operation of the plant was for creating an asset in the shape of the plant and therefore the same does not fall within the purview of royalty, but is business profits for the supply of technical-know-how and documentation. Whether business or royalty income, what decides is the nature of the consideration paid for. If it is paid for a right in the intellectual property, the income is royalty, and if for the purpose of the use of the product, it is business income. The consideration in the latter case is made for the use of the product and not for any right in the underlying intellectual property.

The medium used to deliver the software is no longer of much relevance, when it could be delivered on the internet. The form of delivery has no bearing on the classification of a software transaction.

Whether a transaction in software is a sale transaction or merely a licence in exchange or royalties, depends upon whether the transferee has received the right to use the software in its business but also the right to reproduce and redistribute to others. Income may be derived from sale, rentals, royalties or services. Software transactions are divided into three categories:

- (1) Transfer of a copyright in the computer programme;
- (2) Transfer of a copy of the computer programme (a copyrighted article);
- (3) Provision of services relating to development or modification of the computer programme.

As regards first, transfer all rights means transfer of a capital asset; while transfer of less than all, a licence. In the former case, it is characterised as capital gains and in the latter, royalties. A transfer of copyright results when the transferee has the right to copy the software for distribution to the public or use the underlying code to create derivative programmes.

As regards the second, it involves the transfer of a copyrighted article rather than the copyright itself. It is characterised as the sale of the product, or, if the user has received the right to use the software for less than its

useful life, a licence. It is a transaction involving transfer of a copy of the software programme, where the user does not have the right to redistribute or right to use the underlying code. It is a sale of the copyrighted article (as a product) and not the copyright itself. The transaction is characterised as sale of product.

As regards the third, it is classified as the provision of services when the provider of the service is paid for his rendering services notwithstanding failure of the product to yield the desired or expected results. Transferee bears the risk of product failure. It is a transaction for the development or modification of the programme for other, where that other owns the substantive copyrights and assume the risk. It is characterised as the provision of service.

How the income from the software is characterised also depends whether the software transferred is tangible or intangible property.

Permanent establishment- E-business - Computer equipment, Server, Web site - Recent developments

11.28-4 The Committee on Fiscal Affairs of the OECD has developed Taxation Framework Conditions setting forth the governing principles on the taxation issues related to electronic commerce. These were approved by the Ministers at a Ministerial level Conference on electronic commerce held in Ottawa in October, 1998. The key conclusion was:—

- The taxation principles that guide Governments in relation to conventional commerce should also guide them in relation to electronic commerce.

The Committee believes that at this stage of development of the technological and commercial environment, existing taxation principles can implement these principles. The framework for taxation of electronic commerce addresses four areas: tax treaties, consumption taxes, tax administration, and taxpayer service.

In the tax treaty area, the framework provides that the present international norms are capable of being applied to electronic commerce, but that some clarifications should be given as to how these norms, and in particular the Model Tax Convention, applies. One issue that the Working Party discussed is, whether a web site or a server can constitute a permanent establishment giving rise to tax jurisdiction in a country.

Believing that the principles which underlie the OECD Model Tax Convention are capable of being applied to electronic commerce, the Committee set up the Technical Advisory Group to monitor the application of the treaty norms for the taxation of business profits in the context of electronic commerce. The Working Party discussed some clarifications on the application of permanent establishment definition in the context of electronic commerce, in its report of March 3, 2000 (appended at the end of the chapter as Appendix 5).

Whether a server at a given place may ever constitute a permanent establishment, the Working Party considered a number of issues in relation to the provisions of article 5:—

- ...■ While fixed automated equipment operated by an enterprise may constitute a permanent establishment in the country where the equipment is located, a distinction needs to be made between the computer equipment (which could constitute a permanent establishment under certain circumstances) and the data software which is used by, or stored on, that equipment. For instance, an internet web site is a combination of software and electronic data that does not, in itself, involve any tangible property. It, therefore, cannot constitute a place of business, as there is no facility such as premises or, in certain circumstances, machinery or equipment. On the other hand, the server on which the web site is stored and used is a piece of equipment having a physical location and may thus constitute a "fixed place of business" of the enterprise that operates it. (See para 42.2 of the OECD Commentary on Article 5)
- ...■ The enterprise that operates the server may be different from the enterprise that carries on business through the web site. The latter does not have any right to particular space or control over the operation of the server (as opposed to the operation of the web site software itself). In such case, the server and its location are not at the disposal of that enterprise. It does not have a physical presence at the location since the web site does not involve tangible asset. (See para 42.3 of the OECD Commentary)
- ...■ Computer equipment may only constitute a permanent establishment, if it meets the requirement of being fixed. In order to constitute a fixed place of business, a server will need to be located at a certain place for

sufficient period of time so as to become fixed within the meaning of paragraph 1 of article 5. (*See para 42.4 of the OECD Commentary*)

...■ The location of a server is irrelevant to the customer of an e-commerce operation, since the customer has access to the business goods or services wherever the customer has an internet connections. Thus, the e-tailor's business is carried on, not through the server, but through the enterprise's offices, warehouses, research facilities and other locations in which its income-generating activities take place. Accordingly, the requirement that the e-tailor have a fixed place of business is not met by the server in these circumstances. (*See para 42.9 of the OECD Commentary*)

...■ As regards human intervention necessary for automatic equipment to render that equipment being considered permanent establishment, there are two views. Human intervention is not necessary, according to one, if the nature of the business is such that the activities performed through the equipment are the core income-generating activities. In electronic commerce activities no personnel are necessary to generate income. (*See para 42.6 of the OECD Commentary*)

According to the other, the intervention is indeed necessary for a permanent establishment to exist. There is, however, difference of opinion about the level as also the nature and the extent of the intervention whether it :—

....■ must necessarily takes place in the country or can be done from outside;

....■ needs to be that of the employees of the enterprise or of any person, whether or not employed by the enterprise;

■ Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment located in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4 of article 5. Examples of activities which, by themselves, would generally be regarded as preparatory or auxiliary are:—

....■ providing communications link- much like a telephone line - between suppliers and customers;

....■ advertising of goods or services;

....■ relaying information through a mirror server for security and efficiency purpose;

....■ gathering market data for the enterprise;

....■ supplying information. (*See para 42.7 of the OECD Commentary*)

■ Computer equipment is taken to be permanent establishment if it performs the activities which are the core functions of the enterprise :—

....■ Where sales functions are performed through the computer equipment. Whether the product is delivered on-line or by traditional methods, the equipment would constitute a "place of business" and may a permanent establishment. (*See para 42.8 of the OECD Commentary*)

....■ Where the essential business activity of an enterprise that sells certain products (physical or in the form of software) is the selling of the product itself. The communication tools used in the selling process should make no difference, whether the transaction is concluded by mail order, by telephone or through a server connecting the computer (web site) of the selling enterprise with the computer of the customer.

■ Another issue is whether paragraph 5 of article 5 may apply to deem an ISP to constitute a permanent establishment. It is common for ISP to provide the service of hosting the web sites of other enterprises on their own servers. In that case ISP will not constitute an agent of the enterprise to which the web site belongs, because it will not have authority to conclude contracts in the name of the enterprise and will not regularly conclude such contracts or because it will constitute independent agent acting in the ordinary course of its business, as evident by the fact that it hosts the web sites of many different enterprises. It is also clear that since the web site through which the enterprise carries on its business is not itself a "person" as defined in article 3. Paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph. (*See para 42.10 of the OECD Commentary*)

The OECD Commentary on Article 5 on whether electronic commerce operations of computer equipments in a country could constitute a permanent establishments is based on the above recommendations. The relevant Paragraphs 42.1 to 42.10, are reproduced in the Annex 11.1.

Server-concept of Article 5 applicable

11.28-5 The basic criterion for determining where lies the PE is the totality of economic activities. The activities carried through server, therefore, are to be evaluated to determine whether it constitutes PE, notwithstanding it being of the nature of a technical equipment requiring the least human intervention. The evaluation is made on the ground of economic nexus. Mere gathering market information will not make it a PE. Offering and accepting orders will, however, do. Likewise, management and administration will also do.

Article 5 defines PE in the context of business done traditionally. There is no definition in regard to electronic business. The concepts of Article 5 may be applied to the extent possible in the determination.

The present definition of PE could still be relevant to business carried on electronically. There are many criteria provided in article 5; *viz.*,

- a fixed place of business;
- place of management;
- a factory or workshop; warehouse;
- installation, substantial equipment;
- activities which are not preparatory or auxiliary etc.

Whether a server is PE because of any of these, what has to be found what a server does.

Server, as a substantial equipment, is PE, has been discussed in paragraph 11.20-8.

Server-fixed place of business through which business is carried

11.28-6 In the case of server owned by the enterprise carrying on business, it could be PE, for the reasons discussed below :

To qualify as PE three main conditions are :

- fixed place of business (the existence of a business establishment);
- which is "permanent"; and
- business carried through this fixed location, wholly or partly.

In order to constitute a fixed place of business, a server needs to be located at a certain place for a sufficient period of time as to become fixed within the meaning of paragraph 1 of Article 5. It may be argued that server being an equipment, may not be taken as "place of business" and so a PE. In that case, the room or the office where it is located could be considered for that purpose. But the real question is whether room or an office is necessary for the server to be described as a PE, and whether "place of business" could only mean a physical place, even when no premises is needed or available for doing business.

A place of business, according to paragraph 4 of the OECD Commentary on Article 5 covers any premises, facilities or installations and also a certain amount of space where no premises were available or required. The expression "physical place" would also mean "certain space". Thus, a "place of business" may exist where no premises are available or needed. Physical relevance to or connection with the earth no longer limits the scope of the term "place". "Certain space", where no premises are available or needed for carrying on business, would convey that there must be something in law to suggest that that business could be carried on in a particular jurisdiction without the premises being available or because it is not needed. It may be called "legal place" or a "virtual place". Recent technological development for carrying on business and the blurring of the distinction between the product and the services and the manner of doing business have obviated the need of physical place. The emphasis is not on physical characteristics of a place; but on the legal characteristics as to say that it is "the place" through which the business is carried. Underground pipelines through which oil and oil products are transported and delivered in another jurisdiction were held to be PE (*see* paragraph 1.20-7). In that case no

premises was required to do the business of transporting and delivering oil and oil products. Similarly, if information or digital goods are communicated or delivered in a jurisdiction through cables and server, there could be a PE without the premises being available. As underground pipelines represented PE; sever could likewise do.

Fixed place of business should be taken to mean for business activity, undertaken for a relatively longer period. To perform a business activity traditionally, personnel are required; and to do electronically, web server. To do business, human beings or equipment (*e.g.*, vending machine) is used. There is no difference in doing the business in this or that way. Approach should be similar to income derived from electronic and non-electronic transactions. The OECD in its report dated the 3rd March, 2000, does not admit a distinction between equipment and software, focussing on equipment. Paragraph 10 of the OECD Commentary on Article 5 states that a permanent establishment may exist if the business is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining the equipment. Enterprise may itself set up, maintain or operate or agent may do. That equipment may be taken as a place of business. Thus server is a PE Equipment performs business functions. In *Piedras Negras v. Commr.* (1941) 43 B.T.A 297, income (from the activity of broadcasting) attributable to functions performed by equipment was determined by looking to where the radio's station studio and power plant were located and its personnel performed services. Its basic requirement is a place through which business is carried. As discussed in para 11.5, a place of business means both premises and other tangible assets used for carrying on business, and even one tangible asset is sufficient. It means some manifestation of doing business in another jurisdiction. That manifestation may be in any form. It should be such through which business is carried on, in another jurisdiction. Equipment is the place of business.

The word "through" though may mean "at" or "in" or "from" a place as discussed in para 11.5-4, in respect of traditional business. In the context of electronic business, it may mean the medium or connection as a result of which the business is carried on. Illustrated Oxford Dictionary defines the word through "because of; by the agency, means, or fault of". Readers Digest Word Power defines it "because of; as a result of; connected by telephone". For doing business, medium or some connection is required through which it is done. For doing it traditionally, it is the place, suggesting physical presence (personnel and/or assets) *i.e.*, territorial nexus. Electronic business does not recognise such territorial nexus. For that business, the presence which the new technology is capable of providing would meet the requirement. Instead of doing it traditionally face to face, it is conducted through computer and telecommunication. It does not require the presence of persons. Personal intervention has been done away with or limited to maintenance or operation. Digital goods could be sold or services provided through a computer. That through which the business is carried, is the PE.; in the case of traditional business, it is the "place" *i.e.*, a building or premises, while in the case of electronic business, it is the "computer, *i.e.* , server or website". The word "fixed", as already discussed, defines the location and is not used in the sense of having something transfixed in the land or stationary. If location is determinable and identifiable, it can be said to be fixed (*see* paragraph 11.5). If the location of the server could be ascertained and identified in a jurisdiction, the business could be said being done in that jurisdiction.

Server is the PE, through which electronic business is carried on. It is fixed if its location is ascertainable.

The OECD has released a "Proposed Clarification of the Commentary on Article 5 of the OECD Model Tax Convention ("the revised draft for comments" on March 2000). According to the proposal a geographically and temporary fixed server at the disposal of and operated by the enterprise could constitute a PE of the enterprise.

Server-place of managementServer-place of management

11.28-7 As stated in paragraph 11.15, the place of management is the management's actual location. If the place of management is in a State, the PE is in that State. This criterion is essential when a company, though registered abroad, is managed from that State *via* a server situated abroad. A place of contract may determine the place of management, in the case of electronic business also. As discussed in paragraph 1.9, profit from transfer of goods arises at the place where the contracts of purchase and sale were effected and from services where it is rendered [*see CIR v. Hang Seng Bank Ltd.* (1990) 3 HKTC 351 (SC)]. The trade is exercised it where the contract made [*see Maclaine & Co. v. Smidth & Co.* (1926) 10 TC 481)]. It is not the place where it is negotiated or entered into.

The place where the contracts are made is an important factor in determining the territorial situs. This principle could be applied in doing business through server. A contract is made where acceptance of the offer is communicated. Acceptance of offer would make the contract binding. It would be the place where acceptance is received [*Entores Ltd. v. Miles Far East Corporation* (1955) 2 QB 327], which would presumably the jurisdiction

from which an offer is made. In case of contract entered through mail, the place of acceptance of an offer is where the letter of acceptance is posted [*Imperial Life Assurance Co. of Canada v. Colmaners* (1967) SCR 443]. In case of an instantaneous means of communication, such as telex, it is where the acceptance telex is received. This is on a face-to-face analogy. Thus, in an e-business also, the question is where the binding contract has been concluded; whether with the vendor (web company) or with the consumer (purchaser). The answer depends upon two questions :

- (1) whether electronic communication should be regarded instantaneous;
- (2) whether the information displayed on the non-resident's website constitutes an offer or merely an invitation to treat.

The issue, therefore, depends on the concept of offer and acceptance and the communication through internet. The communication on internet is not instantaneous. The nature of the information displayed will decide; whether displaying the product with or without definite terms of contract, price and terms of delivery. It is an offer in the former and an invitation to treat or bid in the latter. Thus, if a non-resident caused a website to display an invitation to treat which caused say the Indian customers to make an offer to the non-resident, then the operator of the website sent messages to such customers confirming acceptance that ought to fix the place of contract outside India assuming that the server despatching the acceptance message is outside India (the operator of the website is the agent of the offeror similar as a postal authority is the agent of the offeror when acceptance is posted). If the communication on the internet were instantaneous, the contract would have been made in India, *i.e.*, the place of receipt.

Server-factory or workshop

11.28-8 A server has many functions. It may undertake an information-production activity according to a client's individual needs. Information is the processed data. Raw material when subjected to manufacturing end up in finished product different from raw material. Data is like a raw material which when processed end in a product called information. Data may be likened to raw material and information, to a finished goods. The process may be either manufacturing or assembly. Information is the processed data which in a form suitable for the end users. It includes data, text, images, sound, codes, computer programmes, software and database. The processing which occurs to transform data into information includes manipulation (sorting, merging, tabulating), as well as calculation, and will frequently entail the use of the stored data as well as only collected data. "Raw material", "processing", and, the "finished goods" are the three elements in the analogy. The corresponding elements of the computer are input device, central processor device, and, output device. The central processor unit (CPU) is composed of a number of different functional units, namely, control unit, main storage (memory), and, arithmetic logic unit (ALU). The control unit performs three main tasks. It accesses instructions, interprets them, and initiates action; instructions to perform on the data. The main storage (memory) is that part of the total storage of the computer from which instructions are executed. Arithmetic logic unit (ALU) performs actual manipulation of data. It performs both arithmetic and logic operations.

The control unit, main storage (memory) and the ALU are inter-connected.

From the input data travels to main storage. The control unit initiates action by moving the data from the input device to main storage and subsequently to other parts of the computer. The control unit distinguishes between the instructions which it is to follow and the data on which it is to perform them. Arithmetic and logic operations are performed by the ALU which is instructed by the control unit.

In effect, a large scale function as indicated above could be interpreted as "an information factory" in the meaning of article 5(2). As a result, a server could serve as a PE, if it carries out extensive information processing services as per requirement of an individual customer.

Database alone could be interpreted as a warehouse which is used for the purpose of storage or display. In that case it is not the PE.

Server-preparatory or auxiliary activities

11.28-9 A server is not a PE if it performs functions which are of preparatory or auxiliary in character, as covered by paragraph 4 of Article 5. Examples of such functions are : providing a communication link-much like a

telephone line-between suppliers and customers; advertising of goods or services; relying information through a mirror server for security and efficiency purposes; gathering market data for the enterprise; supplying information.

The computer equipment would, however, be a permanent establishment if-

- these functions form in themselves an essential and significant part of commercial activities of the enterprise as a whole, or
- other functions than these are core functions of the enterprise which are carried on through the computer equipment.

Core function of an enterprise doing business is to make sale of goods or services. Where sales functions are performed through the computer equipment, whether the product is delivered on-line or by traditional methods, it would be a PE. It would also be taken PE if it does not perform the sale functions in that manner but used as a communication facilities to conclude sale agreements. The essential business activity of an enterprise is that sells certain products - physical or in the form of software - is the selling of the product itself. The communication tools used in selling process does not make any difference whether the transaction is concluded by mail order, by telephone or through a server connecting the computer (web site) of the selling enterprise with the computer of the customer.

Server-not an agentServer-not an agent

11.28-10 A server cannot be deemed as agent in terms of paragraph 5 of Article 5. An agent is the person who has the authority to conclude contracts in the name of the enterprise. Activities referred to in that paragraph denote active involvement, which a computer, being an equipment, is incapable of. It remains passive throughout.

Server - Whether royalty or business incomeServer - Whether royalty or business income

11.28-11 There has always been characterization difficulty whether income from an electronic transaction be taken as royalty income as arising from the use or right to use a copyright, or as business income arising from providing services. Technology is manifested in the form of drawings, models, formulas and sometimes in the form of an equipment. The definition of royalty covers payments "for the use of, or right to use, industrial, commercial or scientific equipment". Equipment for that purpose may mean an accessory in an industrial, commercial and scientific process and not to any end product. The payment if made not for such use or right to use but for other purposes, it would not be taken as royalty income. The consideration paid has to be identified, whether it is made for a right other than the use or right to use the intellectual property. The question whether the use of such equipment would mean making the technology available or providing service depends on identifying consideration what it is paid for. If it is for the use of the equipment and not for any right in the underlying technology, it would mean providing service. The consideration is paid for the use of the product and not for any right in respect of patent or secret formula or copyright. The expression "right is respect of" is decisive of whether the consideration paid is royalty income or service income. If there is no transfer of any right in respect of the intellectual property and also there is no use of such property but use is of the product produced as a result of the application of such property, the consideration received is not royalty income but the service income.

Identification of the consideration for what is paid may decide; if done for a right other than the copyright (such as other types of contractual rights or such as data or services), it is not royalty. The use of copyright is incidental to the transaction of a purchase of a digital product for own use or enjoyment of the acquirer, such as music, picture or movies or computer programmes.

This is more relevant in case of use of software computer or the software is an "industrial, commercial or scientific" equipment.

The consideration for the use or the right to use it, whether royalty or service income depends on—

- Whether the user has physical possession of the property, control over it, economic and possessory interest in it,
- whether the provider does not bear the risk of substantially diminished receipts or increased expenditure if there is non-performance under the contract and also does not use the property concurrently to provide significant services to others,

- whether total payment does not substantially exceed the rental value of the computer equipment for the contracted period.

Their absence would mean service income and presence royalty income.

TAG examined a few transactions where the issue could arise whether the words " payments for the use of, or the right to use, industrial, commercial or scientific equipment" could cover payments for the use of digital products or computer equipment

Digital products and software

Digital product such as a music or video CD intended for private and personal consumption is not an equipment because of its intangibility, shortness of its useful life and being not an accessory in an industrial, commercial or scientific process. Payments for its use cannot be considered payments for the use or the right to use industrial, commercial or scientific equipment and, thus, royalties. It is immaterial whether the product is downloaded electronically or delivered on a tangible material.

Payments made for the following type of transactions (as per TAG) are treated as business income under article 7 :

(1) Electronic ordering of—

- tangible product which is delivered to the customer by a common carrier ;
- software or other digital product which is down loaded (delivered) to the customer's hard disk (if for purposes of copyright exploitation, royalty income), including updates and add ons ;

(2) Right to use software or other digital product

- for a period of time less than the useful life of the product, either downloaded electronically or delivered on a tangible medium such as CD,
- one time (with no right to make copies), either downloaded or used remotely (*e.g.*, use of software stored on a remote server)

(4) Provider under a contract with the user for a single, bundled fee,—

- allowing access to one or more software applications,
- hosting the software applications on a server owned and operated by the host, and
- providing technical support for the hardware and software

The user can access, execute and operate the software application remotely. The application is executed either at the customer's computer after it is downloaded into RAM or remotely on the host's server. The contract is renewable annually for an additional fee.

(5) Allowing a user to have access, execute and operate the software application hosted on a server owned by the host and customers utilizing the equipment concurrently, having no possession or control over the computer equipment. The application may be executed either at the customer's computer after it is downloaded into RAM or remotely on the host's server. This type of arrangement can apply, for example, for financial management, inventory control, human resource management or other enterprise resource management software application.

(6) Application service provider making available to customers access to a software application hosted on a computer server owned and operated by the provider; customer having no right to copy the software or to use software other than on the provider's server, and having no possession or control of a software copy;

(6) Provider offering space on its server to host website for a fee based on the passage of time, having no rights in the copyright created by the developer of the website contents;

(7) Software maintaining and updates;

(8) Provider owning and operating a server and

- allowing it for a customer to store computer data and to have access, upload, retrieve, and manipulate data remotely; (for example, a retailer who stores its inventory records on the provider's hardware and

persons on the customer's order desk remotely access this information to allow them to determine whether orders could be filled from current stock);

- making a repository of information available for customers to search and retrieve ; or of information of greater value, significant value in terms of content having been added (examples of such products being special industry or investment reports);
- providing the customer with online technical support, including installation advice and trouble shooting information. This support may take the form of online technical documentation, a trouble shooting data base, and documentations (e.g., e-mail) with human technicians. If the provision of on line advice through communications are for the application of special skill and knowledge and are not incidental to the sale of a product, the, it may constitute fees for technical services.

(9) Advertisers paying for their advertisements having been disseminated to users of a given web site. Advertising rates are most commonly specified in terms of a cost per thousand "impressions" (number of times the ad is displayed to a user), though rates might also be based on the number of "click-throughs" (number of times the ad is clicked by user) ;

(10) Professional service provider such as a consultant, lawyer, doctor advising consumers through e-mail, video conferencing, or other remote means of communication. If services are of technical or consultancy nature, it would be taken fee for technical services.

(11) Provider electronically delivering data to subscribers periodically in accordance with their personal preferences

(12) On-line—

- provider making available subscription-based interactive web site featuring digital content, including information, music, video games, etc., as opposed to getting a product or services from the site
- shopping portal (a web site operator) hosting electronic catalogues of multiple merchants on its computer server and transmitting orders, on commission basis, to the concerned merchant of the products selected by the users from these catalogues.
- auctioneer displaying many items for purchase by auction and receiving compensation from the owner of the item on user purchasing items directly from him.
- provider paying a sales commission to the operator of a web site that refers sales leads to the provider.

(13) A content provider—

- providing a particular web site or net work operator in order to have its contents displayed
- receiving from a web site operator for payments for creation of new contents as a result of contractual arrangements. If, however, paid for a right to display copyrighted material would fall under the definitions of royalty to the extent that the public display of the content constitutes a right covered by the copyright of the owner of the content.

(14) Broadcaster receiving subscription or advertising revenues from user having accesses a content database of copyrighted audio and/or visual material.

American Express Bank case - Advance Ruling P. No. 30 of 1999, (1999) 238 ITR 296 (AAR)
American Express Bank case - Advance Ruling P. No. 30 of 1999, (1999) 238 ITR 296 (AAR)

11.28-12 The Authority for Advance Rulings examined the taxability of income of foreign companies engaged in the operation of credit cards and travellers cheques A company ("Y") incorporated in USA belongs to 'ABC' group of companies, which operates in the worldwide credit card and travel business. Y has stored in the Central Processing Unit ("CPU") maintained by it in the US information about all the transactions and other related data in respect of each card holder and traveller's cheque holders. It also maintains a computer set up in Hong Kong, called Consolidated Data Network ("CDN"). It also has a worldwide information processing telecommunication centre ("WPIT Centre") in the US. There is another Indian company (XT) which provides customer services as a high technology centre for data management and information analysis and control, to companies of ABC group and other companies situated in Asia, Europe and elsewhere. Y allows its customers (including XT) to use its CPU and

also various 'ABC' entities to have access to it through CDN. XT has a link up to CDN through dedicated international leased circuit lines of Videsh Samachar Nigam Limited ("VSNL") which is the gateway for international telephony in India.

Transactions executed by credit card holders and traveller's cheque holders in India and the Asian Pacific region are reported to XT. XT accesses Y's CPU through CDN in Hong Kong. It accesses the data on the CPU, updates it, validates the transactions of the credit card holders. XT pays a certain fee for accessing the data and using the CPU.

The question before the AAR was whether the payments due to Y from XT are liable to tax in India and, if so, whether they are to be treated as royalties covered under article 12(3)(a) or article 12(3)(b) of the Indo-US DTAA.

It was ruled by the Authority that transmission of the information through encryption as the data relating to clients by maintaining strict confidentiality and it was for downloading of the software that the royalty was paid. According to the agreement between the applicant and the Indian company, the facilities were to be accessed only by the Indian company and the consideration was payable for the specific programme through which the Indian company was to cater the needs of the group of companies located in Japan, Asia, Pacific etc. The transaction would, therefore, relate to a "scientific work" and would partake of the character of intellectual property. The software was customized and secret. The use of the CPU and the CDN of the applicant by the Indian company was not merely use of or right to use in industrial, commercial or scientific experience as envisaged in article 12(3)(b) of the treaty, but the use of modern technological designs or models involving customized communication and computation with application of sophisticated informational technology requiring constant upkeep and updating so as to meet the challenge of the advance technology in this area which would clearly fall within the ambit of article 12(3)(a) of the treaty.

The AAR answered both the questions referred to it in the affirmative. About royalty income, the AAR reasoned that the use of XT of CPU and CDN is not merely the use of equipment but the use of embedded software which falls in Article 12(3)(a) of the DTAA.

The ruling is not free from controversy. It could be argued, and perhaps rightly, that in order to decide the nature of the receipt, what is required to be ascertained is for what the payment was made and if paid for a right other than a right in the copyright, it is not to be taken as royalty. By permitting XT and also other customers to have access to the CPU and the embedded software, Y did not receive consideration for the transfer of the underlying copyright. The information available on the CPU is the processed data which is in form suitable for the end users. It is for the use of this product XT made payment to Y, and not for any right in respect of copyright. As pointed out in *Dun and Bradstreet Espana S.A., In re* [2005] [272 ITR 99](#) (AAR) that the consideration paid for the use of or right to use any copyright of literary, artistic or scientific work or any patent, trademark or for information of commercial experience is royalty or fees for technical services.

Permanent establishment - India's approach

11.29 India has a territorial type of tax. A resident taxpayer is liable on his income derived in India. He is also liable on his foreign income. A non-resident is liable when the income is Indian sourced. Foreign sourced is not liable, except when there is business connection in India, or when there is PE in case of DTA with the country of his residence. Thus, in relation to residents of treaty countries, if a PE of the non-resident exists in India, the income of that establishment is subject to Indian tax. In relation to residents of non-treaty countries, liability to India tax is simply dependent on income having an Indian source. A branch office, factory, workshop, mine, a construction site for six months or more, or a primary production property generally constitute a PE. An Indian agent (other than a broker or independent agent) who regularly concludes sale, contracts for the non-resident principal or regularly fills orders from India - held stocks also generally constitute PE. On the other hand maintaining a show room, or a warehouse, is not of itself conclusive in determining PE.

India follows the UN Model. Paragraph 3(a) of article 5 of that Model provides for a period of more than six months for building site etc., to be PE; while the OECD favours twelve months. The treaty with Australia, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, UK, provides six months period, with Canada and USA, 120 days, and Norway, three months. That paragraph also deems supervisory activities in connection with assembly installation project as PE, whereas in the OECD Model such is not the requirement. The treaty with Australia, Belgium, Canada, Denmark, Finland, Germany, Italy, Norway, Spain, Sweden, Switzerland, UK, USA covers the supervisory activity. Storage, display or delivery of goods or merchandise if is the purpose of the use of the facility or of maintenance of the stock, such act of use or maintenance is not deemed PE as per OECD Model. The UN Model does not use the word "delivery". It does not

appear in treaty with Australia, Belgium, Denmark, Finland, France, Italy, Japan, Netherlands, Norway, Spain, Switzerland, UK treaty with Canada and with USA uses "Occasional delivery".

Permanent establishment - Treaty with Australia Permanent establishment - Treaty with Australia

11.29-1 Article 5 of the Agreement with Australia though includes some of the provisions of the UN Model. They however, differ significantly as regards range and width.

Paragraph 2 add four other categories besides (a) to (f) of the Model :

- (g) A warehouse in relation to person providing storage facilities for others;
- (h) A farm, plantation or other place where agricultural, pastoral, forestry or plantation activities are carried on;
- (i) Premises used as sales outlet or for receiving or soliciting orders;
- (j) An installation or structure, or plant or equipment, used for the exploration for or exploitation of natural resources.

Paragraph 3 deems an enterprise to have a PE in another State and to carry on business through that PE if:—

- ...◆Substantial equipment is being used by, under contract with the enterprise;
- ...◆It carries on activities in connection with the exploration for or exploration of natural resources;
- ...◆It furnishes services, including managerial services, through employees other personnel, for a period of more than ninety days within any twelve months period.

Paragraph 4 almost repeats paragraph 4 of article 5 of the UN Model, but states that the exclusion will not apply where an enterprise maintains a fixed place of business for any purpose other than those specified in that paragraph.

Paragraph 5 treats a dependent agent as PE on the ground as laid out in paragraph 5(a) and (b) of the UN Model, but also when he secures orders wholly or principally for the enterprise or an associated enterprise, or in so acting he manufactures or processes goods or merchandise belonging to the enterprise.

Paragraph 6 of the UN Model does not appear in the Agreement.

Paragraph 8 provides that paragraphs 1 to 7 may be followed, for the purposes of the interest and the royalties articles, in determining whether there is a PE outside both contracting States or whether an enterprise, which is not an enterprise of one of the States, has PE in one of the States.

Permanent establishment - Treaty with CanadaPermanent establishment - Treaty with Canada

11.29-2 Paragraph 2 of article 5 of the Agreement merges paragraphs 2 and 3 of the UN Model and adds four other categories to the list of categories (a) to (f) of the UN Model:—

- (g) A warehouse, in relation to a person providing storage facilities for others;
- (h) A farm, plantation or other where agriculture, forestry, plantation or related activities are carried on;
- (i) A store or premises used as a sales outlet;
- (j) An installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve-months period.

As for the period for the continuance of the building site or construction, installation or assembly project or supervisory activities, it is more than 120 days, and for furnishing services, more than ninety days, within any twelve-months period.

Paragraph 4 also holds a dependent agent to be PE if he habitually secures orders, wholly or almost wholly for the enterprise.

Permanent establishment - Treaty with FrancePermanent establishment - Treaty with France

11.29-3 Paragraph 2 of article 5 of the Agreement adds three other categories, besides (a) to (f) of the UN Model:

- (g) A warehouse in relation to a person providing for storage facilities for others;
- (h) A premises used as a sales outlet;
- (i) An installation or structure used for the exploitation of natural resources but only if so used for a period of more than 183 days.

Paragraph 3 does not deem supervisory activities and furnishing of services as PE.

Paragraph 6 provides that an independent agent whose activities are devoted to wholly or almost wholly on behalf of the foreign enterprise would not be considered independent, if it is shown that the transactions between the agent and the enterprise were not made at arm's length conditions.

Permanent establishment - Treaty with Germany Permanent establishment - Treaty with Germany

11.29-4 Paragraph 2 of the Agreement adds two other categories, besides (a) to (f) of the UN Model:—

- (g) A warehouse or sales outlet;
- (h) A farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on.

That paragraph reproduces paragraph 3(a) of the Model as category (i). Paragraph 3(b) of the Model is omitted.

Paragraph 3 of the Agreement provides that an enterprise shall be deemed to have a PE and to carry on business through it if it provides services or facilities in connection with, or supplies plant and machinery on hire used for or to be used in, the prospecting for, or extraction or exploitation, of the mineral oils.

Paragraph 4 provides for "delivery", besides "storage or display" as provided in paragraph 4 of the UN Model, as the purpose of the use of the facilities of maintenance of stock of goods or merchandise, for not deeming it as PE.

Paragraph 5 of the Agreement treats a dependent agent as PE on the grounds as 5(a) and 5(b) of the UN Model, but also on additional ground if he habitually secures orders wholly or almost wholly for the enterprise or the associated enterprise.

Permanent establishment - Treaty with Japan Permanent establishment - Treaty with Japan

11.29-5 Paragraph 2 of article 5 of the Agreement adds the following categories to already six of the UN Model:—

- (g) A warehouse in relation to a person providing storage facilities for others;
- (h) A farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;
- (i) A store or other sales outlet;
- (j) An installation or structure used for the exploration of natural resources, but only if so used for a period more than six months.

There is no provision in Paragraph 3 or Paragraph 4 like 3(b) of the UN Model which deems furnishing of services by the enterprise through employees for the purpose of a building site, a construction, assembly or installation, as a PE.

Paragraph 5 deems an enterprise to have a PE and to carry on business through that PE if it provides services or facilities for more than six months in connection with the exploration, exploitation or extraction of minerals oils.

Paragraph 7 deems a dependent agent to be PE, if he exercise his authority in the manner as mentioned in paragraph 5(a) or delivers goods or merchandise on behalf of the enterprise in the circumstances as mentioned in paragraph 5(b) of the UN Model. He is also so deemed if he habitually secures orders wholly or almost wholly for the enterprise or the associated enterprise.

Permanent establishment - Treaty with UK Permanent establishment - Treaty with UK

11.29-6 Paragraph 2 of article 5 of the Agreement adds the following categories, besides those mentioned in the UN Model :—

- (f) Premises used as a sales outlet or for receiving or soliciting orders;
- (g) A warehouse in relation to a person providing storage facilities for others;
- (i) An installation or structure used for a exploration or exploitation of natural resources;
- (k) The furnishing of services, including managerial services through employees or other personnel, other than technical services (royalties and fees), if the activities continue for a period more than 90 days, or the services performed for associated enterprises which continue for a period more than 30 days, within any twelve months period.

Item (h) in the list is reproduction of (f) of the UN Model. Item (j) incorporates in substance paragraph 3(a) of that Model and adds that where such project or supervisory activity, being incidental to sale of machinery or equipment, continue for a period not exceeding six months and the charges payable for the project of the supervisory activity

exceed 10 per cent of the sale price of the machinery and equipment. Paragraph contains a proviso. An enterprise shall be deemed to have a permanent establishment and to carry on business through that establishment if it provides services or facilities in connection with, or supplies plant and machinery on hire used or to be used, in prospecting for, or extraction or production of, mineral oils.

Paragraph 3 adds one more category to the list as in paragraph 4 of the UN Model. It provides the PE shall not be deemed to include the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information or for scientific research, being activities of a preparatory or auxiliary character in the trade or business of the enterprise.

Paragraph 4 deems a dependent agent to be PE also when he habitually secures orders, wholly or almost wholly for the enterprise or the associated enterprise.

Paragraph 7 defines expression "control" in relation to a company to mean the ability to exercise control over the company's affairs by means of the direct or indirect holding of the greater part of the issued share capital or voting power in the company.

Permanent establishment - Treaty with USA Permanent establishment - Treaty with USA

11.29-7 Paragraph 2 of the Agreement adds the following categories to the list as given in paragraph 2 of the UN Model:—

- (g) A warehouse, in relation to a person providing storage facilities for others;
- (h) A farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;
- (i) A store or premises used as sales outlet;
- (j) An installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in twelve-month period;

Item (k) in the list incorporates 3(a) of the UN Model with a change that instead of six months period, the period provided is "120 days in any twelve-month period". In the calculation the period of continuance of other sites, projects or activities is also to be taken into account. Item (l) incorporates the substance of paragraph 3(b) of the Model, if the activities continue for more than 90 days within any twelve-month period. Services performed for an associated enterprise is also included.

The Protocol of Signature provides that where the periods referred to above extend over two taxable years, any period of 30 days in one year is to be left out of account.

For the expression "storage or display" in paragraph 4(a) and (b) of the UN Model, the expression used is "storage, display, or occasional delivery".

Paragraph 4 adds third category to paragraph 4 of the UN Model. A dependent agent is deemed to PE if he habitually secures order wholly or almost wholly for the enterprise.

Paragraph 5 excludes from its rule an independent agent whose activities are devoted wholly or mainly to the one enterprise, and whose transactions with the enterprise are not at arm's length.

APPENDIX 1: BUILDING SITE, CONSTRUCTION, INSTALLATION OR SUPERVISORY ACTIVITIES AND FURNISHING OF SERVICES

Permanent establishment criteria relevant to :

1. Building site or construction or installation project [if lasts for more than 12 months (OECD Model) or six months (UN Model)];
2. Supervisory activities [if lasts for more than six months (UN Model)];
3. Furnishing of services [for a period aggregating more than six months within any twelve-month period (UN Model)].

<i>Name of the country</i>	<i>Building site etc.</i>	<i>Supervisory activities</i>	<i>Furnishing of services</i>
Armenia	270 days	270 days	-

Australia	6 months	6 months	-
Austria	No period mentioned	-	-
Bangladesh	183 days	-	-
Belgium	6 months	6 months	-
Brazil	6 months	-	-
Bulgaria	6 months	6 months	-
Canada	120 days	120 days	90 days
China	183 days	183 days	183 days
Cyprus	12 months	12 months	-
Czechoslovakia	6 months	6 months	-
Denmark	183 days	183 days	-
Finland	6 months	6 months	-
France	6 months	-	-
Germany	6 months	6 months	-
Greece	-	-	-
Hungary	9 months	9 months	-
Indonesia	183 days	183 days	-
Israel	6 months	6 months	-
Italy	6 months	6 months	-
Japan	6 months	6 months	-
Kazakhstan	12 months	12 months	-
Kenya	6 months	6 months	-
Korea	9 months	9 months	-
Libya	3 months (building - or a building site)		
Malaysia	9 months	9 months	-
Malta	6 months	6 months	-
Mongolia	9 months	9 months	-

Mauritius	9 months	9 months	-
Morocco	8 months	8 months	8 months
Nepal	183 days	183 days	183 days
Netherlands	6 months	-	-
New Zealand	6 months	6 months	-
Norway	3 months	3 months	6 months
Oman	6 months	6 months	-
Philippines	6 months	6 months	-
Poland	6 months	6 months	-
Portuguese Republic	9 months	9 months	-
Qatar	6 months	6 months	-
Romania	6 months	6 months	-
Russia	6 months	6 months	-
Singapore	183 days	183 days	183 days
Slovenia	12 months	-	-
South Africa	6 months	6 months	90 days
Spain	6 months	6 months	-
Sri Lanka	183 days	-	183 days
Sudan	6 months	6 months	-
Sweden	6 months	6 months	-
Switzerland	6 months	6 months	-
Syria	12 months	12 months	-
Tanzania	6 months	6 months	-
Thailand	183 days	183 days	183 days
Turkey	6 months	6 months	-
Turkmenistan	6 months	6 months	-
UAE	9 months	9 months	9 months

UAR	90 days	-	-
Uganda	6 months	6 months	-
United Kingdom	6 months	6 months	90 days
USA	120 days	120 days	90 days

APPENDIX 2 : SALE OF MACHINERY AND EQUIPMENT

Permanent establishment is deemed where the assembly project or supervisory activity being incidental to sale of machinery or equipment (if charges payable exceed 10 per cent of the sale price of the machinery and equipment), for a period not exceeding the days as mentioned in the following statement:—

<i>Name of the country</i>	<i>Number of days</i>
Belgium	6 months
Czechoslovakia	6 months
Finland	6 months
Italy	6 months
Romania	6 months
Russia	6 months
Spain	6 months
Turkey	6 months
United Kingdom	6 months

APPENDIX 3 : EXPLORATION OF MINERAL OILS

A permanent establishment is deemed where it provides services or facilities in connection with exploration, exploitation or extraction of mineral oils, if done more than the days as mentioned in the following statement:—

<i>Name of the country</i>	<i>Number of days</i>
Belgium	not mentioned
Bulgaria	not mentioned
Italy	not mentioned
Japan	6 months
Kazakhstan	12 months

New Zealand	not mentioned
Russia	not mentioned
Singapore	183 days
Spain	30 days
Sweden	not mentioned
Turkey	6 months
United Kingdom	6 months

APPENDIX 4 : EXPLORATION OF NATURAL RESOURCES

A permanent establishment is deemed when an installation or structure for the exploration of natural resources provided the activities are carried on for a period exceeding the number of days as mentioned in the following statement:—

<i>Name of the country</i>	<i>Number of days</i>
Armenia	not mentioned
Australia	not mentioned
Belgium	not mentioned
Brazil	6 months
Bulgaria	not mentioned
Canada	120 days
China	183 days
Denmark	183 days
France	183 days
Germany	not mentioned
Hungary	not mentioned
Italy	not mentioned

Japan	6 months
Kazakhstan	12 months
Malaysia	not mentioned
Netherlands	183 days
New Zealand	not mentioned
Norway	not mentioned
Poland	not mentioned
Portuguese Republic	120 days
Romania	not mentioned
Russia	not mentioned
Singapore	120 days
Slovenia	not mentioned
Spain	3 months
Sudan	not mentioned
Switzerland	90 days
Turkey	not mentioned
Uganda	not mentioned
United Kingdom	not mentioned
USA	120 days

APPENDIX 5 : THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN THE CONTEXT OF ELECTRONIC COMMERCE : PROPOSED CLARIFICATION OF THE COMMENTARY ON ARTICLE 5 OF THE OECD MODEL TAX CONVENTION REVISED DRAFT FOR COMMENTS

Introduction

1. In October 1999, Working Party No. 1 on Tax Conventions and Related Questions released, for comments, a proposal for clarification of the Commentary on Article 5 dealing with the application of the permanent establishment definition in the context of electronic commerce.¹ Interested parties were invited to send their comments on that proposal before 31 December, 1999. The introduction to the proposal indicated that the Working Party intended to review and finalize the proposal in light of these comments at its February 2000 meeting.

2. The Working Party wishes to thank the individuals and organizations who have sent comments on the proposal. At its meeting of 22-25 February, 2000, the Working Party has carefully reviewed the proposal in light of these comments and has produced a revised draft (reproduced at the end of this document). It has also decided to follow the suggestion, made by some commentators, to invite comments on this revised draft and to take additional time to deal with this issue. The Working Party intends to finalize its views on the issue at its next meeting, to be held in September 2000.

3. Comments on the attached document should be sent before 15 June, 2000 to :

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4. In presenting this revised draft, the Working Party wishes to stress that, although it has had substantial discussions on the issue, it was felt more useful to present the various positions put forward by delegates, with a view to reaching a compromise solution at a subsequent meeting on the basis of comments received on these various views, than to try to issue another proposal representing majority views.

5. The Working Party also wishes to repeat that this revised draft is concerned solely with the issue of the application to electronic commerce of the permanent establishment definition as it currently appears in Article 5 of the OECD Model Tax Convention and does not, therefore, address the broader and ultimately more important issue of whether any changes should be made to that definition or whether the permanent establishment concept should be abandoned. The Committee on Fiscal Affairs has indicated that it "believes that the principles which underlie the OECD Model Tax Convention are capable of being applied to electronic commerce."² It has set up a Technical Advisory Group to monitor the application of existing treaty norms for the taxation of business profits in the context of electronic commerce. The general mandate of that Group is "to examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules." The work of that group will therefore assist the Working Party in deciding whether changes need to be made to the Model Tax Convention to address this broader issue. Also, as was already mentioned in the previous proposal, the draft below does not address the issue of how much income should be attributed to electronic commerce operations carried on through computer equipment in circumstances where there would be a permanent establishment.

The Working Party's views on some of the comments received

6. The Working Party felt that, in addition to revising its original draft in light of the comments received, it would be useful to present its conclusions on some of the main points raised in these comments. This is done in the following paragraphs.

Whether the draft implicitly suggested that the permanent establishment concept should be amended or replaced

7. A few commentators expressed concern that the preamble of the draft may be taken to suggest that the Working Party considered that the permanent establishment concept should be amended or replaced.

8. As noted in the preamble of the October draft and in paragraph 5 above, the Committee on Fiscal Affairs has already stated that it "believes that the principles which underlie the OECD Model Tax Convention are capable of being applied to electronic commerce". At the same time, however, it has mandated the TAG on monitoring the Application of Existing Norms for the Taxation of Business Profits, among other things,

"...to consider and comment on the following questions :

- (a) whether the concept of permanent establishment provides an appropriate threshold for allocating tax revenues between source and residence countries and with respect to the use of tax havens in the context of electronic commerce;
- (b) whether there is a need for special rules relating to electronic commerce and whether such rules would be a viable alternative to existing international norms."

9. The Working Party notes that the draft dealt solely with the interpretation of the definition of permanent establishment as currently found in the OECD Model Tax Convention. While it cannot rule out that changes could eventually be made to the existing rules, it will await the report of the TAG before considering any such changes as regards e-commerce.

Overall policy considerations

10. Many commentators raised general policy arguments as justification for their conclusions concerning the interpretation of the permanent establishment definition.

11. While the object and purpose of Article 5 is clearly relevant in interpreting its wording, many of the policy considerations put forward in the comments received did not relate to the object and purpose of this Article. Also, the ordinary meaning of the words used in the definition of permanent establishment, taken in their context and in light of the interpretations put forward in the commentary, cannot be ignored in interpreting that definition.

12. For these reasons, these general policy arguments are more relevant for purposes of the work of the TAG on Monitoring the Application of Existing Norms for the Taxation of Business Profits, which addresses the issue of whether the existing treaty rules are appropriate for e-commerce (see above), than for the interpretation of the current wording of Article 5. The Working Party will therefore ensure that these arguments are communicated to the TAG.

The difficulty of allocating profits to a server/permanent establishment

13. Many commentators have focussed on attribution of income issues, suggesting that it would be extremely difficult to allocate profits to a server/permanent establishment. Some of them have also suggested that there was a need to address that issue before deciding the PE issue.

14. The Working Party acknowledged the importance of that concern. It noted, however, that the Committee on Fiscal Affairs had also stated that it believed "that the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing (through the Model Tax Convention and the Transfer Pricing Guidelines) are capable of being applied to electronic commerce." In pursuing this approach, the first question, which is the issue that the revised draft addresses, is whether a server can constitute a permanent establishment. If, in the event it is determined that a permanent establishment exists, it then proves difficult in practice to allocate profits to that permanent establishment, this points toward the question of whether the existing rules in Article 5 should be reviewed. Certainly from a matter of legal interpretation, the logic of Article 7 is that if there is a PE, one must determine what profits are attributable to it. It seems inappropriate to suggest that if attribution proves to be difficult, one should go back and decide there is no permanent establishment.

15. The Working Party also felt that attributing income to functions performed through a server is not exclusively (or even primarily) a permanent establishment problem. The same issue arises even where there is no doubt whatever that a permanent establishment exists (*i.e.*, the web site of a multinational enterprise is stored on a server located in the headquarters or in a store belonging to that enterprise). It may also arise where e-commerce operations are carried on through an associated enterprise (*e.g.*, where the e-commerce operations of a large retailer are carried on by a foreign subsidiary which only owns and operates a website from a server located in its country of residence, the delivery of goods sold through that site and the after-sale services being done from stores operated worldwide and owned by other subsidiaries).

16. Given the importance of clarifying how income should be attributed when business functions are performed through a server, the Working Party agrees that this issue should be given priority by the Committee on Fiscal Affairs. It was also noted that the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits had included that issue in its work programme.

More time should be taken to examine the issue

17. Some commentators suggested that the Working Party should not finalize the proposals at its February 2000 meeting and should invite new comments on its revised draft.

18. As already noted, the Working Party adopted that suggestion and decided to release a new draft for comments with the aim of finalizing its work at a subsequent meeting.

The need for clearer distinction between the various forms of doing business

19. Some commentators have indicated that the different forms of doing business should be more clearly distinguished in the proposed draft, that the reference to the "operation" of a web site or server was unclear and that it should be clarified, in some of the paragraphs, that the statements refer to an enterprise that, for example, owns or rents the server.

20. The Working Party agreed that its proposal could be usefully clarified in that respect and the attached revised draft contains a number of drafting changes that have been made for that purpose.

Payments based on disk space taken up on a server

21. One commentator has suggested that "web space is typically rented on the basis of disk space taken up on the server [...]. Looking at paragraph 4 of the commentary to article 5 it could be argued that the enterprise has this space, which forms part of the premises owned by another enterprise, at its constant disposal." The Working Party rejected that view. It concluded that while each case needs to be examined on the basis of its facts and circumstances, web hosting contracts are generally not contracts for renting disk space or servers, even though part of the consideration may be computed by reference to the amount of disk space used for client.

Whether a server at a given place may ever constitute a permanent establishment

22. Commentators have suggested a number of technical reasons why a server could not constitute a permanent establishment. The following are the views of the Working Party on some of these arguments :

- one needs to distinguish between the server and the software (web site) that is stored on it. Since the web site cannot itself be a permanent establishment and the server is not automated without the software/web site, the server cannot be a permanent establishment. It is difficult to follow that logic. Once software and data are stored and operated from a server at a given place, they contribute to the functions performed there and one must then determine whether the business of the enterprise is carried on from that place looking at everything that happens there. By analogy, while employees who do not have authority to conclude contracts cannot themselves constitute a permanent establishment, one needs to look at the functions performed by these employees in a particular building to determine whether the business of an enterprise is carried on in that building. An empty server, like an empty building, would not itself be a permanent establishment.
- a server plays only a passive role; if there is a series of back-up servers (often in different countries and which may or may not be owned by the enterprise), it is difficult at any point in time to tell whether the main server is playing any role at all. This raises the distinct issue of what is preparatory or auxiliary. It does not affect the fact that a particular server at a given place may constitute a permanent establishment if the functions performed there go beyond what is preparatory or auxiliary.
- a server should not be mere a permanent establishment of mere users than are telephone and data lines, call storing or other information recording or disseminating mechanical machines. This comment avoids the question of why communication equipment does not constitute a permanent establishment for the user. If the communication equipment situated at a given location in another country is owned by the user (who is not in the telecommunication business), the reason why there is no permanent establishment is not because there is no fixed place of business but rather because the activities performed there are preparatory and auxiliary.

23. It has also been suggested that the fact that a server is owned/rented or not should be irrelevant: if the function of the web site is the same, it should be deemed to meet the requirements of the permanent establishment in the

Model Convention. This comment seems to suggest that a web site could constitute a permanent establishment regardless of whether or not facilities, or at least a certain space in a country, is at the disposal of the enterprise operating that site. The Working Party does not agree with that suggestion, which is inconsistent with the current definition of permanent establishment.

Whether human intervention is required for a permanent establishment to exist

24. Many commentators argued that some human intervention was required for a permanent establishment to exist. As reflected in the revised draft, a number of delegates have adopted that view. There were different views, however, as to exactly what that requirement implied, particularly as regards the issue of whether the required human intervention needs to be that of employees or can be that of any persons, whether or not employees.

Preparatory or auxiliary activities

25. Many commentators have offered views as to the scope of the exception concerning preparatory or auxiliary activities in the case of functions performed through computer equipment. The Working Party considered these suggestions. It felt, however, that in many cases, it did not have sufficient information about the scope or purpose of the proposed activities to make accurate judgments about whether the activities generally would be preparatory or auxiliary. For these reasons, even the conclusions regarding those activities that are listed in paragraph 12 of the revised draft should be considered tentative. The Working Party would welcome more detailed information and analysis about the activities noted in previous comments, whether or not those activities have been included in the revised draft.

The application of article 5 in the context of electronic commerce : Revised draft

‘1. There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

2. Whilst fixed automated equipment operated by an enterprise may constitute a permanent establishment in the country where the equipment is located (see paragraph 10 [of the existing Commentary]), a distinction needs to be made between computer equipment, which could constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site is a combination of software and electronic data that does not, in itself, involve any tangible property. It therefore cannot itself constitute a "place of business" ("installation d'affaires" in the French version) as there is "no facility such as premises or, in certain circumstances, machinery or equipment" (see paragraph 2 [of the existing Commentary] above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and used is a piece of equipment having a physical location and may thus constitute a "fixed place of business" of the enterprise that operates it.

3. The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not give to the enterprise to which the web site belongs any right to particular space or control over the operation of the server (as opposed to the operation of the web site software itself). In such case, the server and its location are not at the disposal of the enterprise (see paragraph 4 [of the existing Commentary]), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location; in fact, the enterprise does not even have a physical presence at that location since the web site does not involve tangible assets. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site also owns (or leases) and operates the server on which the web site is stored and used, the enterprise could constitute a permanent establishment of the enterprise if the other requirements of the Article [5] are met.

4. Computer equipment may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved around, but whether it is in fact so moved. In order to constitute a fixed place of business, a server will need to be located

at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1 [of Article 5].

5. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on through equipment such as a server that it controls and operates. Some countries believe that the issue is already dealt with in paragraph 10 [of the existing Commentary], which expressly recognizes that the business of an enterprise may be carried on through automatic equipment. Other countries, however, draw a distinction between the example, given in that paragraph, of a gaming or vending machine and the servers used in electronic commerce operations. These countries consider that in the case of a gaming or vending machine, the machines are in a fixed place and enter into completed transactions with customers to provide goods or services. They note that a vendor who changes locations each week would quickly lose its customers. The location of a server is, however, irrelevant to the customer of an e-commerce operation, since the customer has access to the business goods or services wherever the customer has an Internet connections. Thus, the e-tailer's business is carried on, not through the server, but through the enterprise's offices, warehouses, research facilities and other locations in which its income-generating activities take place. According to these countries, the requirement that the e-tailer have a "fixed place of business" is therefore not met by the server in these circumstances.

6. A further issue is to what extent human intervention is necessary for automatic equipment to be considered to constitute a permanent establishment of an enterprise.

7. Under one view, automated equipment that does not require human intervention for its operation may constitute a permanent establishment. For these countries, the relevant question is the nature of the business and whether the activities performed through the equipment are the core income-generating activities of that business. In this respect, electronic commerce activities can be compared to other activities in which equipment operates automatically, *e.g.*, automatic pumping equipment used in the exploitation of natural resources. It seems illogical to these countries to conclude that personnel are necessary to have a permanent establishment when no personnel are in fact necessary to generate income. These countries cannot find any explicit reference to a requirement of human intervention in the definition of "fixed place of business" and note that paragraph 10 [of the existing Commentary] already recognizes that automatic equipment may constitute a permanent establishment.

8. Another view is that some human intervention is indeed necessary for a permanent establishment to exist. There are different views, however, as to the exact parameters of that requirement. Those differences relate to the following questions :

- whether the intervention must necessarily take place in the country or can be done from abroad;
- whether the intervention needs to be that of employees of the enterprise or of any person, whether or not employed by the enterprise;
- what level of human intervention is required.

9. On the first question, some members consider that the intervention must be that of persons who are present for that purpose in the country where the equipment is located. According to that view, it is only under these circumstances that the enterprise can be regarded as participating in the economic life of that country like domestic enterprises that also employ capital and labour there. This requirement can also be inferred from a comparison with income from employment that can also only be taxed in the country of source if the employer is physically present there to exercise his activities. Others believe that this is the case if, as a matter of fact, it would not be possible to operate and maintain the equipment from a remote location.

10. On the second question, some Member countries consider that an enterprise may only be said to carry on, wholly or partly, business activities in a country through equipment located in that country if the equipment is operated by persons, whether or not employed by the enterprise. Others believe that there is a requirement that this input be made by persons who are employees or dependent agents, though not necessarily authorised to conclude contracts, of the enterprise and note the references to "personnel" in paragraphs 2 and 10 of the Commentary on Article 5 as support for that view. They conclude that, at least in the case of automatic equipment, where the operation and control of the equipment is done by non-enterprise personnel, this requirement is not satisfied.

11. On the third question, there are different views as to which activities would require human intervention for a permanent establishment to exist. While some members consider that what matters is whether or not the equipment is operated, and not merely set up and maintained, by persons, others think that it may be difficult to distinguish the operation from the maintenance of computer equipment, especially when databases are updated or software upgraded.

12. Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment located in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4 [of Article 5]. The question of whether particular activities performed through computer equipment fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which, by themselves, would generally be regarded as preparatory or auxiliary include :

- providing a communications link - much like a telephone line - between suppliers and customers;
- advertising of goods or services;
- relying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

13. All countries agreed that, where such functions form in themselves an essential and significant part of the commercial activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 2 to 11 above), there would be a permanent establishment.

14. There were, however, different views as to what constitutes core functions of the enterprise. Some countries took the view that where sales functions are performed through the computer equipment, whether the product is delivered on-line or by traditional methods, the equipment would constitute a "place of business" and may be a permanent establishment. Other countries draw a parallel with the use of other communication facilities, such as the use of telephone lines to conclude a transaction. These countries are of the opinion that the essential business activity of an enterprise that sells certain products - physical or in the form of software - is the selling of the product itself. The communication tools used in the selling process should make no difference, whether the transaction is concluded by mail order, by telephone or through a server connecting the computer (web site) of the selling enterprise with the computer of the customer. They see this view as in line with the recently adopted changes to the part of the Commentary on Article 12 dealing with software payments, which put forward the view that the form in which a product is delivered (physically or electronically) should make no difference to the way in which it is taxed. Thus, only in exceptional cases do these countries see a possible permanent establishment for this category, for example, if the relevant transaction (the conclusion of a contract, the payment and the delivery of the goods) is handled fully (automatically) by the server itself.

15. A last issue is whether paragraph 5 [of Article 5] may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 [of Article 5] may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISP. While this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph.'

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - INCOME FROM IMMOVABLE PROPERTY

ARTICLE 6

INCOME FROM IMMOVABLE PROPERTY

1. *Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.*
2. *The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.*
3. *The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.*
4. *The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.*

IntroductionIntroduction

12.1 Income from immovable property is taxable in the contracting state in which it is situated. Income from agriculture or forestry is also thus taxed. The income is intrinsically related to the ownership of natural resources of a country. Its state is entitled to tax it. Paragraph 2 of article 6 is elaborate in defining immovable property, in addition to what it means under the law of the contracting state where it is located, as including accessory to it and others. Paragraph 3 is an extension of paragraph 1. If income has relation to immovable property in whatever manner, whether it is derived by direct use or by letting or use in any other manner it is taxable in the state of location. Paragraph 4 extends this principle to an enterprise or performance of independent personal services, if the income has a source from immovable property. Thus, article 6 deals with the income which a resident of a contracting state derives from immovable property situated in the other contracting state. It does not apply to income from the property situated in the contracting state of which the recipient is resident within the meaning of article 4 or situated in the third state. Article 6 is based on the fact that there is always a very close economic connection between the source of the income from immovable property and the natural resources of the country. Paragraph 1 states the general rule. Paragraph 3 clarifies that income referred to in paragraph 1 also means income derived from the use of immovable property, including, but not limited to, income from direct use by the owner (in which case income may be imputed to the owner for tax purposes) and rental income from the letting of the property.

Immovable property - DefinitionImmovable property - Definition

12.2 The definition consists of three parts, referential, inclusive, and, exclusive.

The first part defines the expression "immovable property" with reference to the domestic law of the situs state, as having a meaning which it has under its laws. This helps in avoiding difficulty in interpreting as to whether or not an asset or right in respect thereof is an immovable property. Inclusive definition refers to income from property accessory to immovable property, livestock, and equipment used in agriculture and forestry, rights to which the provisions of the general law respecting the landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working or the right to work, mineral deposits, sources and

other natural resources. The inclusive definition affirms a view that where the income is received in connection with the ownership of "immovable property", it is intrinsically related to the natural resources of the country. That country has, therefore, the right to tax. Property accessory is deemed to be immovable property, even if such accessory is temporarily separated from it. Livestock and equipment are so considered for their intended use in agriculture or forestry. No distinction is necessary according to whether or not the person is the owner of the immovable property in the exploitation of which the livestock or equipment he owns is employed by him.

The exclusive definition excludes ships, boats and aircrafts.

"Immovable property" is defined to mean what it means "under the law" of the State where situated. The expression "under the law" is not confined to the tax laws but also extends to the general law. But conflict may arise if one State regards an item to be immovable and the other movable property; for example, a partner's interest in partnership property. The partnership properties are not held by the partners as co-owners. The property belongs to the partnership and it merely vests in all the partners because the firm has no legal entity. But such vesting does not mean that all the partners are the co-owners of the property (*see Chief Controlling Revenue Authority v. Chaturbhai* AIR 1977 Guj. 1 : *Minish K. Sheth v. State of Gujarat* AIR 1985 Guj. 56). During the subsistence of partnership no partner can deal with any portion of the property as his own ; nor can he assign his interest in specific item of property to any one (*see Adanki Narayanappa v. Bhaskara Krishnappa* AIR 1966 SC 1300). Vesting of the property in all the partners only means that every partner has an interest in the property of partnership. Thus, a partner's interest in partnership land may be regarded by the State where the land is situated as immovable and by the other where the partnership is managed as a movable property. Income arising from such land may be treated differently, in one from immovable and in the other from immovable property. The conflict can be resolved through mutual agreement procedure.

Immovable property - Defined under the Indian laws

12.3 Under the Indian laws, immovable property has been defined to include land, benefit to arise out of land and things attached to the earth, or permanently fastened to anything attached to the earth [General Clauses Act, 1897, section 3(36)]. The Indian Registration Act, 1908 [section 2(6)] defines it to include land, buildings, hereditary allowances, rights to ways, lights, ferries, fisheries, or any other benefit to arise out of land, and things attached to the earth or permanently fastened to anything which is attached to the earth but not standing timber, growing crops, nor grass.

Interests in land, whether classified according to their nature, such as legal estates and equitable interests, or limited in duration, such as terms of years, or independent of the right to possession of the land, such as profits, are interests in immovable property. Even rights over the physically movable chattels which have inseparable relation with land, are also taken to be immovable property, such as title deeds, fixtures, fish in pond. Right vested in a mortgagee may be regarded as interest in immovable property, though under certain circumstances the real character is a debt and not a charge. Mere existence of a collateral security over the land does not alter the fact that the debt is a chose in action.

The following are some of the instances which have been judicially recognized to be immovable property—

- ◆Right to collect rents of immovable property, to collect dues from a fair on a piece of land, to receive future rents and profits of land, to collect lac from tress;
- ◆Right of way, of ferry, to fishery ;
- ◆A debt secured by mortgage of immovable property; the equity of redemption, the interest of the mortgagee in immovable property ;
- ◆Revision in property leased ;
- ◆Hereditary offices.

But right of worship, a decree for sale of immovable property, a decree for arrears of rent, right to recover maintenance allowance, standing timber, growing crops and grass, are not immovable property.

Immovable property - Property accessory

12.4 Article 6 extends to any tangible movable property that has been placed on the immovable property so that it remains permanently attached thereto, and which thereby constitutes property accessory or annexed to the immovable property within the meaning of the domestic law of the Contracting State in which the property is situated. This article speaks of immovable property and not the claim or right save the right to which the provisions

of the general law respecting landed property apply, rights to variable or fixed payments as consideration for the working of the property, or the right to work, mineral deposits, sources and other natural resources.

For the purpose of determining whether a movable property attached to an immovable property is an immovable property the enquiry should be not whether the attachment is direct or indirect but what is the nature of the attachment and what is the object and purpose. The degree and nature of attachment no doubt should be a consideration, but the more important consideration should be the object of annexation which is a question of fact to be determined by the circumstances of each case. If a thing is embedded in the earth or attached to what is embedded for the permanent beneficial enjoyment of that to which it is attached, then it is a part of immovable property and if the attachment is merely for the beneficial enjoyment of the chattel itself, then it remain chattel, even though fixed for the time being so that it may be enjoyed and, therefore the question in each case must depend upon the intention of annexation and that such intention may be either express or implied from the circumstances. In the absence of proof one way or the other, the intention to be attributed is that of a person acting from motives of self-interest.

Immovable property - Test for holding movable as immovable property

12.4-1 The following test will determine as to when a movable property fixed to the earth becomes an immovable property - *South Indian Bank Ltd. v. Krishna Chettiar & Bros.* AIR 1976 Mad. 215.

- ◆-Intention of the parties
- ◆-Mode of affixation and whether the affixation is intended to be permanent
- ◆-Onus of proof that even after annexation the article continues to be movable is on the person who alleges it.

In *Mohammed Ibrahim v. Northern Circars Fibre Trading Co.* AIR 1944 Mad. 492, a machinery was fixed to cement platform and attached to iron pillars fixed in the ground to a depth to nearly 6 to 7 feet. It was held that as there was no reason to think that the owner of the factory intended to keep the machinery of the mill and the land to which it was affixed apart and that his object was to become the owner of both for the purpose of carrying on the business for his own individual benefit, the machinery which stood annexed to the floor should be treated as immovable property.

In *J. Kuppanna Chetty, Ambati Ramayya Chetty & Co. v. Collector of Anantapur* AIR 1965 AP 457, a boiler engine and decorticator were fixed and embedded in the factory building for the beneficial use of building as a factory was held to be immovable property in addition to land and building. In *Perumal Naicker v. Ramaswami Kone* [1968] 2 MLJ 493, the Madras High Court has held that engine mounted on cement base and fastened to it by bolts and nuts was not immovable property as the intention of fixing the engine to the earth is not to make it permanent part of the earth and that the nature of the engine and the purpose of its annexure both show that it cannot be regarded as an immovable property, that though the engine stood affixed to the earth the purpose of such affixture is necessary for the user of the engine and such an affixture cannot be viewed as a permanent one. The view taken by the court was that for a chattel to become part of immovable property and to be regarded as such property it must become attached to the immovable property as permanently as a building or a tree is attached to the earth and if the property is movable property and for its beneficial use or enjoyment it is necessary to embed it or fix it on earth though permanently, that is when it is in use, then it cannot be regarded as immovable property for that reason.

In *Hemendra Lal Roy v. Indo-Swiss-Trading Co. Ltd.* AIR 1955 Pat. 375, it was held that until power house is dismantled, the machinery, etc., which are fixed to the earth are uprooted, and until buildings are demolished, structures, plants, machineries, transmission lines, etc., cannot be called movable properties.

In *Carborandum Universal Ltd. v. CIT* [1984] [146 ITR 1](#), the Madras High Court held that the owner of the undertaking has embedded the machinery in the earth for the purpose of working his factory as a press, it should be taken to come within the definition of 'immovable property'.

Immovable property - Manner how used not relevant

12.5 Irrespective of the manner how an immovable property is to be made use of whether by its exploitation as a commercial asset, i.e., by carrying on business by its owner by the employment of such an asset, or as an investment by letting it or renting it out to another on lease or on rental or by using it in any other manner directly or otherwise the income is assessable in the Contracting State in which it is situated.

Paragraph 4 of article 6 states that the provisions of paragraphs 1 and 3 would be applicable to income derived from immovable property used for the performance of professional services.

If the source of income is the immovable property, it is liable to tax in the country of the location though under certain circumstances such income could be taken to be business income under domestic laws. For example, when an assessee derives any income by exploitation of a commercial assets whether himself or through the agency of another, such income is normally taken to be business income - *CIT v. Prem Chand Jute Mills Ltd.* [1978] [114 ITR 769](#) (Cal.) and *CIT v. Katihar Jute Mills (P.) Ltd.* [1979] [116 ITR 781](#) (Cal.). According to this view, the source of income being the business, the article which controls its taxability would be article 5 and article 7. Such income would not be taxable at all if it arises or accrues from the activity which does not fulfil the requisites of permanent establishment in terms of article 5. Taxability or the non-taxability of income depends on the existence or non-existence of the permanent establishment, and its extent upon how much of it could be attributed to the permanent establishment, if existed. The concept of taxability of income on the basis of location of its source would then be relegated to insignificance. But paragraph 4 makes it clear that the view does not prevail if the source of income is immovable property. Notwithstanding that property belongs to industrial, commercial enterprise, or is used for the performance of independent personal service or used for non-industrial or non-commercial purposes, the income from such property is taxable in the State of source. Thus, the right to tax of the State of source has prevalence over the right of the other State. Though the right of the source State predominates, this article does not provide how the income from immovable property be determined. Its provisions, therefore, do not prejudice the application of the domestic law as regards the manner in which income is computed and tax determined.

Income derived from direct use, letting or indirect useIncome derived from direct use, letting or indirect use

12.5A Sub-paragraph (3) of the Article defines the scope of income taxable as income from immovable property. It refers to income derived from the direct use, letting, or use in any other manner from the immovable property. The use in any form other than the direct use or letting, could only refer to deriving income from its transfer. If an asset is employed, say, by way of investment and produces income, the income arises or springs from the asset. The operation which causes the income to spring from the asset is the operation of investment. In the operation of investment, income is produced while asset continues to belong to the assessee, whereas in the operation of sale, gain is produced, which is still income but in the process, the title to the asset is parted with. Although the process involved in the two cases are different, the gain which has resulted to the owner of the asset, in each case, is the gain which has sprung or arisen from the asset [*see Sevantilal Maneklal Sheth v. CIT* [1968] [68 ITR 503](#) (SC); and *Manubhai A. Sheth v. N.D. Nirgudkar, Second ITO* [1981] [128 ITR 87](#) (Bom.)]. The expression "use in any other form of immovable property", therefore, may also refer to the operation of sale of that property. The gain arising from such operation is the gain which has sprung from the property which is treated as income in the manner as the income arising from the operation of its direct use or letting. The gain which is termed as "capital gain" is the income from immovable property. The Supreme Court in the *Sevantilal's* case (*supra*) did not agree with the argument that capital gain is not the income arising from this asset. The Supreme Court again rejected a similar argument in the case of *CIT v. P.V.A.L. Kulandagan Chettiar* [2004] [267 ITR 654](#), wherein it held that capital gain is an income and Article VI of the Agreement for Avoidance of Double Taxation of Income between India and Malaysia covers capital gains, and that income derived from the sale of immovable property situated in Malaysia is not taxable in India.

Immovable property - India's approachImmovable property - India's approach

12.6 India's approach with respect of taxation of income from immovable property is that only the State where the property is situated has the right to tax.

Tax treaty with AustraliaTax treaty with Australia

12.6-1 The treaty uses the expression "real property", though the heading of the Article also uses "immovable property" in the parenthesis. They, therefore, convey the same meaning. The former is used with reference to the property situated in Australia; the later, with reference to India. As regards India, the definition follows the UN Model, though livestock and equipment used in agricultural and forestry are not included. As for Australia, real property has the meaning which it has under the Australian laws and includes a lease of land and any other interest in or over land, right to receive variable or fixed payments as a consideration for the working of or the right to work minerals or other deposits, oil or gas wells, quarries or other place of extraction or exploitation of minerals.

The UN Model specifically excluded "ships, boats and aircraft". The treaty does not so exclude.

Paragraph 3 of the Agreement provides that a lease of, or any other interest in or over, land etc., if situated where the land is situated.

Tax treaty with GermanyTax treaty with Germany

12.6-2 Paragraph 1 does not include income from agriculture or forestry as income from immovable property. The expression "immovable property" has not been defined under the article. It has been done under general definition article 3 and worded in the manner as done in paragraph 2 of article 6 of the Model.

Tax treaty with USATax treaty with USA

12.6-3 The article follows the Model, except that the first part of the definition is adopted; inclusive and exclusive parts not included. The treaty also uses the expression "real property", which is not different from "immovable property".

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - TAXATION OF BUSINESS PROFITS

ARTICLE 7

BUSINESS PROFITS

- 1. 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 enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.*
- 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.*
- 3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.*
- 4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in*

paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary ; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year-by-year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.

Note : The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.

IntroductionIntroduction

13.1 The business profit of a foreign enterprise is taxable only if it has a permanent establishment in the other Contracting State. Article 7 is a corollary to article 5 where under the expression "permanent establishment" has been defined, and, therefore, has to be read in continuation of that article. The taxability of business income of a foreign enterprise depends upon a question whether the enterprise has a permanent establishment in the source State, and, another question, what are the profits on which the permanent establishment should pay tax. For an answer to the first, reference has to be made to article 5; and for the second, to article 7. The concept of permanent establishment determines the tax jurisdiction of the source State. The possibility is thereby averted, of the dispute between States regarding taxability of income. The tax claim of the two States both legitimately interested in taxing business income is regulated by articles 5 and 7.

The underlying concept of article 7 is that the profits of an enterprise of a country is not taxable in another country unless the enterprise carries on business in that another country through permanent establishment situated therein. The permanent establishment is loosely described as branch of that enterprise in another jurisdiction. The profit attributable to that branch is taxable. Article 7 prescribes rules whereby the attributable profits are determined. For that matter the branch is assumed as an independent entity of the head office. The effect is to limit the quantum of taxable income, which is arrived at by what is popularly known as the attribution rule. The UN and the OECD models follow this rule. The UN model, however, extends the scope by what is known as the force of attraction rule. There are also some variations between the two models.

Article 7 and Article 9 - DistinctionArticle 7 and Article 9 - Distinction

13.1-1 Article 7 deals with determination of profits of the branch (PE) of a foreign company. It provides rule for the attributing income to a country when earned by the multiple units of a single entity. However, rules for allocating income from related party transactions among related entities are dealt with in article 9. That articles provides for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both the enterprises are members of the same group of enterprises or under the same effective control. There are two enterprises, one each in the Contracting State. For Article 7, there is only enterprise with its branch (PE) in the other State. These two articles (articles 7 and 9) incorporate a number of directives, though not very precise for dealing every kind of problem that may arise when an enterprise in one State makes profits in another. They are not absolute or exhaustive. There could be other ways to apportion profits. Paragraph 4, therefore, provides for the application of a customary apportionment.

Business profits - Right of source State exclusiveBusiness profits - Right of source State exclusive

13.1-2 The right of the source state is exclusive in respect of profits attributable to the PE. Article 7 opens with the clause "the profits of an enterprise of" shall be taxable only in that state unless the enterprise carries on business in the other Contracting State through permanent establishment situated therein. The residence state has the exclusive right to tax the business profit of its enterprise, but not the profit which is attributable to the permanent establishment situated in the other state. The profit of the PE is not taxable in the residence state. It is taxable by the Source State. In that context the expression "may be taxed" in the paragraph 1 of article 7 would only mean "shall be taxed" because the profit attributable to PE having not to be taxed in the residence state, has to be done in the source State. The profit of the enterprise is allocated between the source and the residence state; the former having exclusive right over that portion which is attributable to the PE and the latter, over the remaining.

Business profits - The UN Model and the OECD ModelBusiness profits - The UN Model and the OECD Model

13.2 The UN Model and the OECD Model differ with respect the following:—

- ◆ Under OECD Model only so much business profit of an enterprise is taxable as is attributable to the permanent establishment. Under the UN Model, not only such profit is taxable but also the profit which is due according to the force of attraction rule. Such profit is the profit which is attributable to sale of the goods, or merchandise of the same or similar kind as those sold through permanent establishment, or attributable to same or similar kind as those effected through permanent establishment. Thus business income which is not associated or connected with the permanent establishment becomes taxable in the source country, irrespective of whether the establishment has been instrumental in the generation of that income.
- ◆ For paragraph 3 of the UN Model, the following paragraph appears in the OECD Model:—
 "In determining the profits of a permanent establishment, there shall be allowed as deductions of expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere".
- ◆ Paragraph 3 of the UN Model is elaborate to prevent the abuse of transfer pricing device adopted in the intra-firm transactions. The value attached to transfers between an enterprise which is managed by a transnational corporation and its affiliates is not set by an independent transferor or transferee, but is within the discretion of the single enterprise. Sale of goods, provisions of services and licensing of technology are the principal vehicle for transfer pricing abuse. The paragraph, therefore, does not permit deduction of certain expenses stated to have been incurred by the Head Office, or by way of interest or royalty or technical fee unless the payer establishes that payments were consistent with normal commercial practices. The paragraph, therefore, places artificial restrictions on the intra-firm transactions.
- ◆ The OECD Model provides in paragraph 5 that no profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise. The UN Model does not contain such a provision. In a note, however, it is stated that this matter should be settled in bilateral negotiations.

Business profits - Force of attraction rule

13.3 The rule of force of attraction means that all income arising from all sources in a country, where the foreign enterprise maintains a permanent establishment, is subject to tax in that country. Profits arising from transactions outside the permanent establishment are also taxable. The permanent establishment attracts to itself all of the profits derived by the enterprise from the jurisdiction where it is located. This rule is the natural corollary of taxing an income on the source principle. Non-business income may likewise be attracted into the taxable income of the permanent establishment. What the rule of force of attraction really means is this. If a foreign enterprise has a permanent establishment in a taxing country, any other income from sources within that country are automatically regarded as income attributable to that establishment. The developing countries are exponent of this rule, though they would limit its application to business profits covered by article 7 of the OECD Model Convention and not extend it to income from capital (dividends, interest and royalties) covered by other treaty provisions, as also not to the profits which could be attributed to the activities relating to purchase or to sale through independent commission agents. Business profits, as customarily defined, do not include interest, rent, royalty, dividend, and the like *i.e.*, the income from capital, unless such profits are attributable to the permanent establishment or effectively connected with it. The opposition by the developed countries to this rule stems from the non-desirability of taxing income from an activity that is totally unrelated to the establishment as also from the uncertainty that this rule will create for the taxpayers. The compromise between the opposing views is sought by providing that the rule of "force of attraction" is limited to sale of goods or merchandise and other business activities in the following manner:—

- ◆ If an enterprise has a permanent establishment in other Contracting State for the purpose of selling goods or merchandise, sale of same or similar kind may be taxed in that State if they are not effected through permanent establishment;
- ◆ If business activities, other than mentioned above, of the same or similar kind are performed without any connection with the permanent establishment, a similar rule as stated above would apply.

Thus, the profits attributable to the aforesaid activities are also subject to tax in other Contracting State along with the profits attributable to the activities of the permanent establishment itself. Business income is taxed if there is a

permanent establishment. Non-business income is also taxed, if it accrues or arises through or is effectively connected with that establishment. Paragraph 1 of the UN model is the amplification of the corresponding provision of the OECD Model Convention, as it gives jurisdiction not only to the profits attributable to the permanent establishment [clause (a)] but also to those arising from the transactions outside the permanent establishment [clauses (b) and (c)].

Force of attraction - Same or similar goods or business activities

13.3-1 Under the force of attraction rule, profits may be taxed in the source State which is attributable—

- (a) to the PE;
- (b) sales activities of goods or merchandise of the same or similar kind;
- (c) other business activities carried on the same or similar kind

The expression "same or similar kind" appears in clause (b) qualifying goods or merchandise, and in (c) qualifying business activities. The emphasis of clause (c) is on the nature of the activities which may include sales activities also. Accordingly, all sale activities irrespective of the nature of goods or merchandise would attract force of attraction rule. But clause (b) restricts the scope to the activity of sale as those sold through the PE.

Sometimes in deciding whether there is "sameness" or "similarity" between the two kinds of goods or merchandise or between two kinds of business activities, difficulty may arise. The word "same" means resembling in every aspect, identical, and "similar", almost resembling or alike. Nature, functions, purpose, and utility of goods or merchandise are the factors to be taken into account, to decide whether goods or merchandise are similar nature may be the same, but functions and purpose different or *vice versa*. For example, computers and copying machines are both office machines, but designed for different purposes and therefore, not similar goods; hardware and software being complimentary products and often purchased together and from functional point of view parts of the same unit, viz., data-processing machine, are similar goods (Arvid A Skaar ; Permanent Establishment). Whether sales activities of similar goods or merchandise through an agent attract the force of attraction rule depends on whether the agent is dependent. If independent, there is no attraction as such an agent is not deemed to be a PE.

As regards similarity of the business activities relating to construction work, it is to be seen whether work is of construction nature and not the kind of construction. Construction activity embraces activities of a mason, plumber, electrician, welder, carpenter etc. All activities though they may not of the same kind, yet similar in nature, i.e., construction activities. Business activities covering such construction activities are similar business activities.

Business profits - Attribution rule

13.4 Paragraph 1 of Article 7 states the general rule that business profits of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries business in that other Contracting State through a permanent establishment as defined in Article 5, situated there. Thus, if an enterprise carries on business in other Contracting State, the income is not taxable in that State if there is no PE. It is taxable only if it is there. Income is taxed on net basis which is attributable to (a) permanent establishment, (b) activities of same or similar type (as discussed in the previous paragraph). The concept of "attributable to", as discussed in paragraph 9.28-9", means a reasonable nexus between the profit and the business activity. The profits attributable to permanent establishment may be from sources (assets or activities) within or without a Contracting State. Articles 5 and 7 of the UN/OECD Model relate to taxation of the business income of the non-resident. What is required to be established for the purpose is (1) whether he is actually trading in the country rather than trading with it, and (2) what are the profits. The first is to be established by locating his business presence (permanent establishment) on the basis of the criteria laid down in article 5. The second is determined by article 7. All income or profits of an enterprise of a State are taxable only in the State of residence save in two cases :—

1. The profits of a business carried on through permanent establishment in another State and attributable to such permanent establishment;
2. Income or profits which are dealt with separately in other articles of the agreement.

As for the first above, article 7 provides rules of computation of business income. The rules are:—

- a. The profit of an enterprise of a Contracting State is taxable only in the State of residence;

- b. It is taxable in another State if the enterprise carries on business through a permanent establishment situated therein;
- c. In case (b) above, the whole of the profits is not taxable. Only so much is taxable as is attributable to that permanent establishment (and also, where the UN model is followed, attributable to sales in that State of goods or merchandise of the same or similar kind as those sold through permanent establishment, and, also attributable other business activities of the same or similar kind as those effected through that permanent establishment);
- d. The attributable profit can be determined by the apportionment of the total profits of the foreign company to its various parts if such apportionment is customary. Otherwise, it is done on the basis of a hypothesis that the profits which the permanent establishment might be expected to make as if it were a distinct and separate enterprise engaged in the same and similar activities under the same and similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment;
- e. Attributable profits are determined by the same method year-by-year unless there is good or sufficient reason to the contrary;
- f. No profits is attributed to a permanent establishment by reason of mere purchase of goods or merchandise for the enterprise (such provision does not find place in the UN Model);
- g. In determining the profit of a permanent establishment all expenses incurred for its purposes are allowed as deductions, including executive and general administrative expenses so incurred irrespective of where done. The UN model, however, additionally provides that no such deduction shall be allowed in respect of the amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by permanent establishment to the head office of the enterprise or any of its other offices, by way of
 - ..♦royalties, fees or other similar payments in return for the use of patents or other rights;
 - ..♦commission for the specific services performed or for management;
 - ..♦interest on money lent (except in the case of a banking enterprise);
 Likewise if the permanent establishment has charged amount from the head office in respect of the aforesaid, it is not taken into account in the determination of its profits unless the amount is the reimbursement of the actual expenses.
- h. Where profits include items of income which are dealt with separately in other articles, then the provisions of those articles shall not be affected by the provision of article 7.

The combined effect of these provisions is that tax on business profits made by a resident of a treaty partner from sources in the jurisdiction of another partner is not so much shared between the States (as treaties provide with respect to interest, dividends and royalties) as allocated either to one State or to the other. Where there is no permanent establishment in the State of source the total taxing power is allocated to the State of residence. Where there is a permanent establishment, the State of source has the full taxing power with respect of income attributable to its jurisdiction. It means that whatever tax has to be paid by any other company in India has to be paid by a foreign company. The quantum is, however, limited only the extent as indicated. It is not absolved from paying tax which is paid by any other company in India on the ground of its foreign status. In a ruling the Authority for *Advance Rulings (P. No. 14 of 1997, In re [1998] 234 ITR 335 (AAR))* held that the fact that the applicant company was a tax resident of the Netherlands and had got only a permanent establishment in India did not make any difference in the position of law as regards its parity with other companies in India in the matter of tax liability under section 115JA (minimum tax liability on zero tax companies).

Only so much profits as is attributable to permanent establishment - meaning

13.4-1 A permanent establishment (PE) of a person is also deemed to be an independent person and consequently an enterprise capable of entering into "transaction" with the enterprise of which it is a PE, and also with other parts of that enterprise. Article 7 of a tax treaty deems a PE to be a separate and distinct entity from the enterprise of which it is a PE, for the purpose of determining profits attributable to it as accruing in the state in which it is located. The Supreme Court in *DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#), observed "under the said article, a PE is treated as if it were an independent enterprise (profit centre) *de hors* the head office and which deals with the head office at arm's length." The underlying concept of that article is that the profits of the enterprise of a

country A will only be taxed in another country B if the enterprise carries on its business in that country through PE situated therein, on so much of the profits as are attributable to the PE. Article 5 defines the concept of PE and article 7 prescribes the principle whereby "attributable profits" are determined. The attribution is determined on the hypothesis : PE were an independent entity dealing with the enterprise of which it is a PE on arm's length basis.

The expression "only so much of the profits as is attributable to that permanent establishment" in article 7(1) used for the purpose to determine profits, could be interpreted in two ways, according to the OECD Discussion Draft August 2004—

- (1) relevant business activity (RBA) approach; and
- (2) functional separate entity (FSE) approach.

Relevant business activity approach—

- Article 7(1) imposes a limit on the profits that could be attributed to, under Article 7(2) to a PE;
- The attributed profits could not exceed the profits that the whole enterprise earns from the relevant business activity ;
- The profits of the whole enterprise would be those earned from the transaction with third parties and those earned from transactions with associated enterprises ;
- The profits from the associated enterprises need to be adjusted under transfer pricing rules if they did not reflect the application of the arm's length principle.

Functional separate entity approach—

- Article 7(1) is interpreted as not affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that the right to tax of the host country does not extend to the profits that the enterprise may derive from that State otherwise than through the PE, *i.e.*, there is no 'force of attraction' resulting from the existence of a PE;
- The profits attributed to the PE are the profits that the PE would have earned at arm's length as if it were a distinct and separate enterprise performing the same or similar functions or similar conditions, determined by applying the arm's length principle under Article 7(2).

Functionally separate approach - Preferred

The functionally separate entity approach preferred because it is simpler, more administrable, and more consistent with the understanding of the arm's length principle as applied in the context of article 9. It is simple because it does not impose any profit limitation on the profits attributable to the PE that might affect determination of the profits attributable to the PE in accordance with the arm's length principle under Article 7(2). It is administrable because it does not require the host country to try and determine the enterprise's world-wide profits from the relevant business activity (except where a profit split method is applied). It is consistent because it mirrors the type of analysis that would be undertaken if the PE were a legally distinct and separate enterprise. Further, it is more likely to produce a profit attribution in respect of a particular business activity, which is neutral as to whether the activity is carried on by a resident or a non-resident enterprise.

Business profits - Attribution or apportionment of profits

Thus, there are two methods to determine the income of permanent establishment : (1) attribution method (direct method), (2) allocation method (indirect method). The indirect method, *i.e.*, the allocation method is based on a single entity approach. Under this method "profits to be allocated to the permanent establishment are determined as a fraction of the company's worldwide profits corresponding to the involvement of the permanent establishment in generating those profits and computed by reference to factors such as relative gross income, assets and payroll" (*see* IBFD International Tax Glossary, 5th edition) The enterprise of which it is a PE is taken a single entity. Direct method is based on separate entity approach, *i.e.*, the PE a distinct and separate entity. This method is more appropriate.

The basic principle of the Indian tax laws as regards chargeability to tax of a non-resident is that income accrues or arises to, or is received by, him in India or is deemed to accrue or arise or be received. Section 9(1)(i) brings into the Indian tax net all income of a non- resident which has some nexus in India, as business connection, or with a property, an asset or source of income of a capital asset giving rise to income. A business connection is postulated where the non-resident does not carry all operations that give rise to accrual or arisal of profits in India itself but

carries on some systematic operations in India which can be treated as contributing to the accrual or arising of the ultimate profits of the business. Section 9(1)(i) read with *Explanation 1* thereto enacts that, where a non-resident earns from a business, the entirety of operations of which is not carried on in India, it will be taxable in India not on the totality of the profits of the business as a whole but only on so much part of the profits as is reasonably attributed to the operations carried on in India. This can be done in two ways. The profits attributable to the business operations in India can be separately ascertained and assessed if that is possible; or alternatively, the entire profits of the business ascertained and apportioned.

Business profits - Attribution rule and Indian Income-tax Act

13.5 The Indian Income-tax Act, 1961, as aforesaid, contains provisions which correspond to "attribution rule", known as "business connection". This is in operation with reference to transactions with a resident of a country with which India has no tax agreement. If all the operations of a business are not carried out in India, the profits and gains are deemed to accrue as are reasonably attributable to that part of the operations carried out. If no business operations are done, income accruing or arising abroad through or from any business connection in India cannot be deemed to accrue or arise in India - *CIT v. Toshoku Ltd.* [1980] [125 ITR 525](#) (SC).

The expression "Business connection" postulates a real intimate relation between the trading activity carried on outside the taxable territories and the trading activity within the taxable territories, the relation between the two contributing to the earning of income by the non-resident in his trading activity - *CIT v. R.D. Aggarwal & Co.* [1965] [56 ITR 20](#) (SC). To conform the requirements of business connection, it is necessary that the common thread of mutual interest must pass through the fabric of the trading activities carried on outside and inside of the taxable territory and the same has been described as real and intimate connection. The commonness of interest may be by way of management control or financial control or by way of sharing of profits. It may come into existence in some other manner, but there must be something more than mere transactions of purchase and sale between principal and principal in order to bring the transaction within the purview of the concept of "business connection" as envisaged by section 9(1)(i) and section 163(1)(b) of the Indian Income-tax Act, 1961 - *CIT v. Hindustan Shipyard Ltd.* [1977] [109 ITR 158](#) (AP). In *CIT v. Energomach Exports* [1998] [101 Taxman 253](#) (Kar.), the court held that since the foreign Company had no other interest in Indian Company except sale of machinery and supply of personnel for installation and commissioning the same there was no business connection. In *Carborandum Co. v. CIT* [1977] [108 ITR 335](#) (SC), the Supreme Court considered whether making services of foreign technical personnel available to the Indian Company amounts to business connection. The Court held that it will not. It held that supply of technical personnel and technical personnel know-how by foreign company to the Indian company for erection of plant and machinery and expenses incurred thereto will not amount to business connection.

The concept of "business connection" has now been extended to an agent (dependent or independent under certain circumstances) of a non-resident, with an *Explanation* inserted by the Finance Act, 2003, w.e.f. 1-4-2004, to section 9(1)(i) of the Income-tax Act, 1961. With this extended meaning, the concept has now become at par with the PE under the Double Taxation Agreements.

Taxable income is based on PE accounts generally prepared on accepted accounting principles and the requirement of double taxation agreement, if any, as an independent and distinct entity.

Those accounts are subject to adjustments if necessary—

- ◆•when the transactions between the PE and its head office require recharacterisation for taxation purposes;
- ◆•for allocation of head office expenses as may be said relating to the PE;
- ◆•disallowance while making computation of income and tax as per Indian Income-tax Act, 1961

The first relates to arm's length principle and transfer pricing discussed later.

Business profits - Meaning

13.6 Business profit means income derived by an enterprise from the conduct of a trade or business including income from providing or furnishing services. The India and US treaty defines it to mean "income from any trade or business including income from the furnishing of services other than included services as defined in article 12 (Royalties and fees for included services) and including income from the rental of tangible personal property other than the property described in paragraph 3(a) of Article 12 (Royalties and fees for included services)". That treaty further clarifies that the profits to be attributed to the permanent establishment shall include only the profits derived

from the assets and the activities of the permanent establishment. Thus, if the source of income is either the activity or an asset of permanent establishment, it is taxable as business income irrespective of the nature of the activity or the asset. For example, if income bears the nature of dividends, royalties or interest, as arising from the assets of the permanent establishment, it is taxable as its business income. Income from services obviously mean income from providing material or commercial services. Material services involve an activity carried on through the co-operation between employers and employees to provide to the community with the use of something, such as electric power, water, transportation, mail delivery, telephones and the like. In providing such services there may be employment of trained men and professional men. The emphasis is not what these men do but upon their productivity of service organised as an industry and commercially viable. It is the production of something which is described as the production of material services. Services of professional men involving benefit to individuals according to their needs such as doctors, teachers, lawyers, solicitors etc., are not covered. Such services are easily distinguishable from material service which is brought into existence quite apart from the benefit to particular individual. There is a separate article dealing with such professional services *i.e.*, article 14. The contents of article 7 and article 14 are the same, though phraseology is different. What is "permanent establishment" to business the "fixed base" is to the professional services and other activities of independent nature. If the professional activity is tinged with a commercial character and indicia of commerce are manifest in it, such an activity could be taken as business activity. In that case article 7 becomes relevant. A doctor who has acquired X-ray plant undertakes the job of doing X-rays for other doctors along with that of his own patients as an aid for diagnosis may be said carrying on commercial activity. His activity is no different from a non-qualified person carrying on a radiological clinic. Any kind of commercial activity telescoped to professional activity ought to be understood as business, as is properly understood. In such circumstances it may be that the business aspect of the activity springs from the professional activity of the person concerned and is irretrievably connected with it. The concepts of "business" and "business profits" are discussed in detail later, in the context of the Indian Income-tax Act, 1961. The expression "business" has been defined in the Act and "business profit", in various decision of the courts under that Act.

Article 7 deals with only profits from business activities, with the exception of activity of transportation by ship or aircraft for which a separate article is provided in the treaty. There are certain other income-generating activities which are not business activities, such as maintenance of investment resulting in dividends or interest and servicing of patents and technical services contracts resulting in royalties and technical fees. For such activities also there are separate provisions. However, they are treated as business activities and income resulting therefrom (dividends, interest, or royalties and fees for technical services) as business profit if they are effectively connected with the PE.

Business profits - Investment income (royalties, dividends, and interest)Business profits - Investment income (royalties, dividends, and interest)

13.7 If the source is the activity or the asset of the permanent establishment, income is taxable as business profit. Income by way of royalties, dividends and interest is also taxable as business income if the receipt represents the measure of profits of business activity of the enterprise. The profits of an enterprise do not change the character as profits merely because they are differently characterised. The nature of a tax treaty is such as being designed to attribute to the foreign company a measure of income to represent its Indian business. Commercial and industrial profits are not be subjected to tax unless it is engaged in business in India through permanent establishment. The tax is to be imposed only on so much of them as is attributable to that establishment. This is done on a hypothesis that the branch is an independent establishment of the head office and its dealings with it and others are at arm's length. The profits which emerge from a calculation on that basis is deemed income to have been derived in the source country as business income. Income from assets of the permanent establishment is thus its profits and is taxable as such. This is also made clear by articles 10, 11 and 12. There are two exceptions; the foreign company (not the permanent establishment) making investments in shares etc., or, the foreign company having no permanent establishment, income is not taxable as business income irrespective of that investment in shares or on interest etc., are integral part of the activity of doing business. Only if they are received through permanent establishment and the investment is effectively connected with such establishment, *i.e.*, the right to such income is on account of the asset or business of that establishment, then their taxation is determined as if business income, in pursuance of article 7. The article is thus a special provision relating to taxability of business profit which may arise from an activity or asset. Dividends, interest, royalty arising from the asset of the permanent establishment is assessed as business profit (cf. Paragraph 4 of articles 10,11,12 and paragraph 2 of article 21 of the UN Model). The OECD commentary also so states, "It is understood that the item of income covered by special articles may, subject to the

provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States".

The concept of PE is of great importance because of the causal connection of the profits sought to be taxed with the PE. General rule for taxation of royalties and technical fees at a specified and low rates is provided in article 12(1) and (2) which will not apply as the payments are taxable in terms of article 7, if—

- (i) the beneficial owner of these kinds of payments carries on a business through PE;
- (ii) the payments in question arise in the course of such business;
- (iii) the payments are effectively connected with such PE.

The assessment should, however, be restricted to such part of the business profits as are attributable to the actual operations.

Whenever any amount of royalty or fees becomes payable (whether as a lump sum or as periodically recurring amount), it has to be identified whether it is being done in respect of the right, property, information, or services used or utilized for the purpose of a business carried on in India or for the purpose of making earning any income from any source in India. If royalties or fees for technical services are paid for their use in India, it is sufficient, under section 9(1)(vi) and (vii) of the Indian Income-tax Act, 1961, to consider as accruing or arising in India. But para 5 of article 12 requires the fulfilment of further condition before such royalties and fees can be deemed to arise in India where it has a permanent establishment, viz., that the royalties or fees are borne by such PE.

Business profits - effectively connected Business profits - effectively connected

13.7-1 An income which is fixed or determinable periodically such as dividends, interest, or royalties is subject to withholding tax at a fixed rate prescribed under section 115A of the Indian Income-tax Act, 1961, or under a treaty, but on a net basis as business income if effectively connected with the PE. "Attributable to" and "effectively connected" with the PE are different concepts. Profits and gains can be said to be attributable if there is a direct and proximate connection between the profits and gains and the PE. As observed in *Walsh v. Rother District Council* [1978] 1 All ER 510 (QB), the connection need not be that of sale, dominant cause and effect; and materially contributory connection is quite sufficient [see *CIT v. Dalmia Cement (Bharat) Ltd.* [2002] [253 ITR 725](#) (Delhi)]. The definition of PE presupposes performance of business activity. The carrying on of the business of the enterprise is the basic requirement of a PE (see OECD Commentary, article 5, paragraph 2). Profits and gains are the result of regular and continuous business activity. But in case of effectively connected, income is not the direct result of the business activity of the PE but has relation or connection with that activity or the asset of the PE., i.e., it is owing to the business activity of or produced by the asset of PE. Para 92 of the Technical *Explanation*, US Model Convention, provides, "The 'attributable concept' of paragraph 2 is analogous but not entirely equivalent to the 'effectively connected' concept in Code section 864(c). The profits attributable to a permanent establishment may be from sources within or without a Contracting State." The *Explanation* clarifies that the term "effectively connected" income differs from "attributable profits." They are not analogous.

Section 9(1) and *Explanation 1* thereto, of the Indian Income-tax Act, 1961, deems income arising from any business connection in India (and only such income as arising from the business operations carried out in India if all the operations are not so carried) as accruing or arising in India. The DTA also provides similarly that profits will be taxed from a business if carried through a PE, but only on such part of the profits as are attributable to PE. The provision of many of the DTAs is, however, wider than of the Indian Income-tax Act. It is just possible that that the PE may be carrying on operations both in India and outside. In that event, profits attributable to PE would not only be the profits attributable to its operations in India but also the profits which are effectively connected with the PE, though such operations of the PE may be carried on inside India.

Similarly, if outside activities are integrally connected with the project in India, the royalties and fees for technical services in relation to outside activities can be said to be effective connected with PE in India. The Authority for Advance Rulings *P. No. 13 of 1995* [1997] [94 Taxman 171](#) (AAR) observed:

"All 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, the Indian conditions. The PE in India has an undoubted voice over the outside activities as well and the royalties and fees in question cannot but be described as effectively connected with it.

Therefore, the royalties and fees for technical services in relation to 'outside' activities of the applicant are effectively connected with PE of the applicant in India."

Royalties or technical fees in relation to the right, property or contract effectively connected with the permanent establishment or the fixed place, are also treated as business profits (*see* section 44DA of the Indian Income-tax Act, 1961)

Business profits computation - Royalties and technical services etc. Business profits computation - Royalties and technical services etc.

13.7-2 Paragraph 3 of article 7 provides that in determination of the profits of the PE, expenses which are incurred for the purposes of the PE will be allowed as deductions but in accordance with and subject to limitations of the domestic taxation. The Supreme Court in *DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#), observed:-

"A foreign enterprise is liable to be taxed in India on so much of its business profits as is attributable to the PE in India. The quantum of the taxable income is to be determined in accordance with the provisions of the Income-tax Act. All provisions of the Income-tax Act are applicable including provisions relating to depreciation investment losses deductible expenses, carry forward and set off of losses etc. However, deviations are made by the DTAA in cases of royalties, interest etc. Such deviations are also made under the Income-tax Act (for example section 44BB, 44BBA etc.)." For computation of business profits the relevant provisions under the Indian Income-tax Act, 1961, are sections 28 to 44C. But for computing income by way of royalties etc., in case of foreign companies special provisions are contained in section 44D (for agreements prior to 1-4-2003) or in section 44DA (for agreement after 31-4-2003), section 44D starts with an overriding expression "notwithstanding anything to the contrary contained in sections 28 to 44C...". This means that section 44D has application in respect of royalties or fees for technical services in the course of a business and that its special provisions take precedence over section 28 to 44C and override these provisions. Section 44D is, therefore, a substantive section, making a special provision for computing the income by way of royalties and fees for technical services, in the case of a foreign company. The machinery for taxation of such royalties and technical fees is provided in section 115A(b). If the special provisions had not been enacted, royalties or fees for technical services would have been taxable only as business income under the provisions of sections 28 to 44C. The entire scheme of the Act - sections 9(1)(vi) and (vii), section 44D and section 115A - clearly shows that the underlying idea is to give a special tax treatment to income by way of royalties and fees for technical services of foreign companies in two ways : by prescribing a flat lower rate than the general rate of tax on other income by taxing the gross amount of receipts of this nature without providing for any deductions therefrom and a mode of taxation evolved after a great deal of thought and discussions between nations where double taxation is evolved (*see Advance Ruling Petition No. P-6 of 1995* [1998] [100 Taxman 206](#) (AAR).

Section 44DA of the Indian Income-tax Act, 1961, also provides that where a non-resident or a foreign company carries on business in India through a PE situated therein, or performs professional services from a fixed place of profession situated therein, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed place of profession, as the case may be, shall be computed under the head "Profits and gains of business or profession" in accordance with the provisions of the Act. The proviso under that section provides that no deduction shall be allowed which is not wholly and exclusively incurred for the business of the PE or the fixed place, and in respect of amounts, if any paid (otherwise than towards reimbursement of actual expenses) by the PE to its head office or any of its other offices.

The mode of taxation and relief provided in DTA also shows that royalties and fees for technical services are taxed on a basis different from business except where they are in the course of a business with a permanent establishment.

Section 115A of the Indian Income-tax Act, 1961, deals with tax on dividends, royalty and technical fees in case of a foreign company and non-resident assessee, which is not effectively connected with the PE or the fixed place. It is a special provision relating to foreign companies or non-resident assesses having taxable income as dividends, royalties or technical fee etc. Sub-section (3) precludes the application of sections 28 to 44C and renders income by way of dividends, royalties, technical fees etc. taxable at specified rates subject to certain conditions. Sub-section (1) specifies special rates of tax. It consists of two clauses: clause (a) applies to foreign companies and a non-resident assessee deriving income by way of dividends or interest on moneys lent in a foreign currency to the Government or an Indian concern or income from units of certain mutual funds purchased in a foreign currency. The specified rate of tax is twenty per cent. Clause (b) applies where the total income of a foreign company or a non-resident assessee includes income by way of royalties and fees for technical services received from the

Government or an Indian concern under an agreement entered into after 31-3-1976. However, before such section 115A could apply to the agreement it should be approved by the Central Government or in accordance with the Industrial policy of the Government of India. If these conditions are fulfilled, the royalties and fees will be chargeable to tax as provided in the section, viz., 20 per cent (10 per cent with effect from 1-4-2006). There is, however, a disadvantage; the rate of twenty per cent will be applied to the entire gross receipt by way of royalties and technical fees without any deductions for expenses which might have been available if they had been processed in the normal course as profits of the business, under sections 28 to 44C and as income from other sources, under section 57.

The question whether income by way of royalties or fees for technical services are to be computed in accordance with the provisions of sections 28 to 44C (or under section 57) and appropriate rates applied or computed not in accordance with those provisions but the rates of ten per cent applied to the gross amount, depends on whether the provisions of section 115A are applicable to the facts of a case:

- if they are not applicable to a foreign company which carries on business in India through a PE, the profits attributable to the PE will be computed in accordance with article 7 of the DTA read with section 44DA of the Income-tax Act and the gross amount taxed at the appropriate rate to the amount thereof.
- If they are applicable, the profits attributable to the PE will be computed in accordance with article 7 of the DTA read with sections 28 to 44C but the gross amount of royalties and fees for technical services included therein will be charged to tax at the rate of twenty per cent (ten with effect from 1-4-2006) and the balance of the profits, if any, at the tax appropriate to the quantum thereof.

In the first case, the rates of tax applicable will not be that provided under section 115A but will be the rate of tax appropriate to the total income of the company, and, the amount taxable will be not the gross but the net amount arrived at after deduction of expenses incurred for earning of such income.

Thus, whether section 44DA or section 115A applies, it is to be seen whether the foreign company has PE or fixed place in India and the income by way of royalty or fees for technical services is effectively connected with such PE or fixed place. If so, section 44DA applies. Otherwise, section 115A applies, if the agreement is approved by the Central Government or it is in accordance with the industrial policy for the time being in force. If none of the sections applies, the computation is to be done in accordance with the provisions of section 28 to section 44C of the Act. In other words net amount of the receipts after deduction of expenses permissible against the gross receipts under sections 28 to 44C or section 57 will be assessable to tax at the rate of income tax applicable to such income in the hands of a foreign company.

If royalties or fees are earned as business income, but the foreign company does not have any PE in India, income will not escape taxation on the ground that article 7 of the DTA is not applicable. It would be taxed under article 12, which is a special provision for taxation of royalties and fees for technical services. Authority for Advance Rulings in Petition No. P-6 of 1995 [1998] [100 Taxman 206](#) (AAR) observed (head note) :

"It is an accepted fact that the applicant does not have a PE in India. Therefore, article 7 of the DTA would not be applicable. But this does not allow the applicant's profits escape taxation, because article 13 (Indo/UK treaty, corresponding to article 12 of the model) makes special provision for taxation of royalties and fees for technical services. It is an accepted norm in interpretation of DTAA, as indeed all documents, that special provisions take precedence over general provisions, like that article 7 unless specifically excluded and, therefore, the payments received are taxable in accordance with article 13 of the DTA. Moreover, the language of article 13 itself is quite clear on this. Royalties and technical fees fall under article 13 of the DTA except where they arise in the course of a business which has a permanent establishment here or where they are relatable to independent personal services. Only in these eventualities will these receipts attract article 7 or article 15 as the case may be. It has been specifically provided in article 13(6). In the present case, the second part of the above exception has no relevance. The first part also has no application since the applicant has no permanent establishment here. It is, therefore, not possible to accept the applicant's contention that royalties and technical fees should be assessed, if at all, under article 7 as business income. This is one more reason for not considering section 44BB (Indian Income-tax Act, 1961) as applicable to the instant case for the provisions of the DTAA will not only be relevant but will also govern the mode of taxability of a particular class of income. In other words, royalty and technical fees have to be assessed in the manner set out in article 13, unless it can be taken out of such treatment on the terms of article 13(6) or section 44D clearly excluded."

Business profits - Technical fee

13.8 A question may arise whether any income which accrues or arises to a non-resident in respect of a fee for consulting activity in connection with the installation of plant, etc., by deputing personnel could be said as relating to business activity or such activity be taken to mean a "business connection". Fee received for rendering technical assistance or consultancy activities and training of personnel, if necessary, for the construction of plant, bringing into production, for preparation and supply the drawing and documentation for the production of the operating tools, for the preparation and supply of technical documentation for production of non-standard equipment to be installed in the plant, for rendering personnel and technical assistance and consultancy services for starting and in the initial run of the production in the plant, cannot be disassociated from the activity of erection of plant. The foreign company may charge in two ways, (i) payment of salaries of the personal deputed by it; and, (ii) consultancy fee for rendering technical assistance and consultancy services. A major portion of the services are rendered in the source state. The consultancy fees must be said to have arisen from the activities in that state and so much income as is attributable to such activity is taxable in India - *Skoda Export v. Addl. CIT* [1983] [143 ITR 452](#) (AP).

Business profits - Lump sum amount received for transfer of right to receive interest

13.9 If a company lends to its subsidiary company an amount on loan for certain specified period, and a few days thereafter it assigns its right to receive the interest under the loan to a finance company on some consideration, a question may arise whether such amount constitutes income in the hands of the recipient and if it does, another question, whether such amount represents business income. It is an established proposition of law that a contractual right of interest is not the source of interest, and a contractual right severed from the principle debt is not the structure which produces the interest. The source is the principle debt. The sale by the lender of his right to interest for a lump sum consideration converts future income into the present income. The consideration for the assignment of a right to future income may constitute income *in praesenti* in variety of circumstances. Sale of capital asset for periodic, regular and recurrent receipts, converts capital asset into income with periodicity, regularity or recurrence. A thing which can be converted into income can reasonably be regarded as giving rise to income - *Bhagwan Dass Jain v. Union of India* [1981] 128 ITR 315 (SC). Conversion of capital asset into income is not confined to sale alone. Right to receive interest in future of the amount of loan given now may represent a specie of property or capital asset; but realisation of consideration for its assignment may not represent realisation of capital asset. The assignment is not unrelated to loan agreement. It is not unusual in a commercial world that a lender advances loan to the borrower under the belief that he would be able to assign his right to receive the principle amount of loan together with interest for a consideration. If his financial position is not happy, he would not enter into a loan agreement unless he knows that a finance company or a bank would not shortly after such agreement take an assignment of the moneys due or to become due for a sum approximating the amount payable in consideration for the assignment. From the taxpayer's point of view, the two transactions are essential and integral elements in an overall profit making schemes.

The immediate source of income is the assignment of a right, and not the right to receive interest which has already become due or accrued. Right to receive interest in future has not yet ripened into a source which has yielded interest, though such right relates or receiving interest. The source from which interest could be derived has not yet been ascertained; *viz.*, the period for which the money has been retained or used or for which the indebtedness continues. For determination of the source of income from which income is derived, an enquiry has to be made into the genealogy of the product. But the enquiry should stop as soon as the effective source is discovered - *CIT v. Raja Bahadur Kamakhya Narayan Singh* [1948] [16 ITR 325](#) (PC). The moment one comes to the immediate and effective source, one ought not to go any further - *Mrs. Bacha F. Guzdar v. CIT* [1952] [22 ITR 158](#) (Bom.) and *Hindustan Lever Ltd. v. CIT* [1980] 121 ITR 951 (Bom.).

The immediate and the effective source is the assignment of a right to receive interest in future. The contractual right to interest is not the source of interest. Such an assignment smacks of business characteristic, or be termed as a venture in trade. The sale by the lender of his mere right to interest for a lump sum consideration converts future income into present income, though the nature of income may not be the same or similar on the ground of analogical extension of the proposition that when a person converts capital sum into annuity for future and the character of the amount spent for purchase get transformed from capital to income. Thus, lump sum received by the taxpayer as consideration for the transfer of his right to receive interest represents his business income.

Business profits - OECD authorised approach and arm's length transactions between the permanent establishment and its parent company

13.10 Paragraph 2 of article 7 conveys the underlying assumption that the "permanent establishment" is treated as if it were an independent entity for the purposes of establishing profits, *i.e.*, the transactions between it and the head office are determined at arm's length basis and, thus, the profits, which such an independent enterprise might be expected to derive - *Ostime (Inspector of Taxes) v. Australian Mutual Provident Society* [1960] 39 ITR 210 (HL). Also *see DIT v. Morgan Stanley & Co.* [2007] [292 ITR 416](#) (SC). Only the business profit which is attributable to the permanent establishment is taxable in the source country. Article 7 specifies how it should be ascertained. It is done by means of a given hypothesis. Income or profit is presumed to be the amount which the permanent establishment is expected to make if it were an enterprise distinct and separate from the enterprise of which it is the permanent establishment, engaged in the same and similar activities under the same conditions and dealing wholly independently. The establishment is treated as if it were completely independent of the head office and were dealing with it at arm's length. The profit thereafter is determined on the basis which an independent enterprise might be expected to derive on its own. The control, influence, or supervision of the head office with respect to its transactions or commercial relations with the permanent establishment has to be ignored. These transactions are evaluated and their effects ascertained on the doctrine of arm's length as if between two independent organisations. The purpose of article 7 is to attribute to a foreign company doing business in a state a reasonable sum of income or profit with respect to that business as arising in that state so that it could be taxed as is done with respect to income of a domestic company. The taxing provisions is designed to attribute to the foreign taxpayer a measure of income to represent income of PE business.

This is also the functionally separate entity approach which is OECD authorised approach.

Functionally separate approach - OECD Authorised approach

The Working Party of the OECD decided to adopt the functionally separate entity approach as the authorised OECD approach. The OECD authorized approach is that—

"the profits to be attributed to a PE are the profits that the PE would have earned at arm's length as if it were a legally distinct and separate entity performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under article 7(2). The phrase 'profits of an enterprise' in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that 'the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment' (*i.e.* , there should be no 'force of attraction principle') [*see* OECD Discussion Draft August 2004, para 29]"

In paragraph 54, the Discussion Draft provides, the interpretation of Article 7(2) under the authorized OECD approach. A two-step analysis is required—

- First, a functional and factual analysis undertaken in order to appropriately hypothesise the PE and the remainder of the enterprise (or a separate segment or segments thereof) as if they were associated enterprises, each undertaking functions, using assets, and assuming risks.
- Second, an analysis of the Guidelines (OECD Guidelines, 1995) relevant to applying the arm's length principle to the hypothesized enterprises so undertaking functions, using assets, and assuming risks.

Under the first step a full and actual analysis of the functions performed by the PE is undertaken, to determine the economically relevant characteristics relevant to the performance of, say distribution, function by the PE, for example, the identification of a business strategy such as market penetration scheme. Under the second step it would be important to identify any business strategy in order to undertake properly the comparability analysis of the dealings between the PE and the rest of the enterprise of which it is a part and transactions between independent enterprises.

Permanent establishment (PE) is not legally or functionally separate from the enterprise of which it is the PE. It is not the same as a subsidiary. There is no transaction, but dealings, between the separate parts of the same enterprise. The dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. Such dealing, however, is accepted as equivalent to transaction that would have taken place between independent enterprises acting at arm's length. For the purposes of transfer pricing

rules, it may be treated as subsidiary of the head office. Para 55 of the OECD Discussion Draft of the Attribution of Profits to Permanent Establishment (August 2004) reads:

"The authorized OECD approach seeks to postulate the PE as a hypothesised distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and to attribute profits to the PE under Article 7, using the guidance on the application of the arm's length principle of Article 9 given by the OECD Transfer Pricing guidelines, by applying these Guidelines by analogy and, where required, by adapting and supplementing these Guidelines to take into account factual differences between a PE and a legally distinct and separate enterprise. In this context, it should be noted that the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. There are generally economic differences between using a subsidiary and a PE. Application of the authorized OECD approach should achieve equality of treatment between different types of PE, but will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits. Thus, it might be expected that business done through PEs is actually more profitable because of the possibilities of efficient capital utilization, risk diversification, economies of scale etc."

The OECD Discussion Draft discusses various aspects to the recognition of the dealings between a PE and the rest of the enterprise of which it is a part (*see* para 65)—

- First, a PE is not the same as a subsidiary, and is not in fact legally and economically separate from the rest of the enterprise ;
- Second, dealings between a PE and the rest of the enterprise normally have no legal consequences for the enterprise as a whole. This increases the scope for tax motivated transfers between the two and also acts to reduce the usefulness of any documentation (in the inevitable absence, for example, of legally binding contract) that might otherwise exist. Before dealing is accepted as equivalent to a transaction that would have taken place between independent enterprises acting at arm's length, a threshold test to be passed. A functional and factual analysis will determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise. Such dealing as structured by them will be compared with the transactions between independent enterprises.
- Third, where dealings are capable of being recognised, they should be priced at arm's length basis, assuming the PE and the rest of the enterprise to be independent of one another. This should be done following a factual and functional analysis.

Thus, the two-step analysis requires—

- (1) Step 1 - determining the activities and conditions of the hypothesized distinct and separate enterprise, such as —
 - a. functions (activities),
 - b. assets used and the conditions of use,
 - c. risks assumed,
 - d. capital attribution; 'free capital', 'funding cost'.
- (2) Step 2 - determining the profits of the hypothesized distinct and separate enterprise based on comparability analysis involving—
 - a. application of the transfer pricing methods to attribute profits;
 - b. comparability analysis.

Functional analysis under the step 1 is undertaken in order to have attribution to the PE of functions, assets, risks, and free capital. After having so done, attribution of profits to the PE is determined in accordance with its functions, assets used and risks assumed by comparison to independent enterprises performing the same or similar functions, using the same or similar assets and assuming the same or similar risks.

Accordingly, the authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm's length as if it were a legally distinct and separate enterprise performing the same or

similar functions under the same or similar conditions, determined by applying the arm's length principle.

Two kinds of analysis are required to be undertaken—

- Functional analysis *vis-a-vis* the principal enterprise- Functional analysis is undertaken to determine the activities and conditions of the PE being a hypothesized distinct and separate enterprise from the enterprise of which it is a PE. Since the PE is deemed to be an independent and separate enterprise it is necessary to identify economic activities and responsibilities of the enterprise as a whole and how much of them associated with the PE, and how they relate to each other. A functional analysis attributes functions, assets and risks to the PE, and sufficient "free" capital is attributed to support those functions, assets and risks.
- Comparability analysis *vis-a-vis* uncontrolled enterprise. Determination of the profits of the PE being a hypothesized separate and distinct enterprise is based on a comparability analysis. Comparability analysis is undertaken for determining the profits to be attributed to the PE, based on its functions performed and assets used and risks attributed. The PE should obtain an arm's length return for its functions, taking into account the assets used and risks assumed, in the same manner as would a comparable independent enterprise. The "transaction" between the PE and its head office or any of its affiliates requires determination whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of that "transaction". The PE is to be compensated for the functions performed by it in relation to the "transaction" on arm's length basis. Compensation should reflect not only the functions performed but also the assets used and the risks taken in performing those functions.

The functional analysis and comparability analysis both require determining—

- functions (activities) performed by the PE,
- assets used,
- risks assumed,
- capital attribution to and funding of the PE
 - ♦•measuring the risks and valuing assets,
 - ♦•determining 'free capital',
 - ♦•adjusting interest expenses.

PE-Functions performed - PE is deemed to be a distinct and separate entity of the enterprise of which it is a PE and its dealings with the rest of the enterprise as if it is a transaction between two independent parties at arm's length. Functional analysis in that context seeks

- to identify and compare the economically significant activities and responsibilities undertaken by the PE *vis-a-vis* the activities and responsibilities of the enterprise as a whole and
- to determine which of the identified activities and responsibilities of the enterprise are associated with the PE and to what extent; for example, functions performed at the "fixed place" through which business of the enterprise is carried on Article 5(1) or the function undertaken by a dependent agent [Article 5(5)] on behalf of the enterprise

Functions performed by the personnel of the enterprise as a whole including the PE ('people functions') is also to be taken into account, to assess their significance if any in generating the profits of the business. They may be routine, or key entrepreneurial - risk taking (KERT) or somewhere in between. The KERT are those which require active decision-making with regard to most important profits generators. These are to be identified. They are particularly of significant importance in financial and not so in non-financial sector. They may assume importance in non-financial sector also where, for example the creation of valuable intangibles is a key profit driver.

While undertaking a comparison of conditions, some factors other than the functional analysis are to be taken into account (such as characteristics of the property or services, contractual terms, economic circumstances and business strategies) in order to ensure that the conditions of a hypothetical independent enterprise are the same or similar to those of the PE.

Activities on behalf of the PE, even if performed in a different jurisdiction, and those performed by the PE on behalf of other parts of the enterprise, are taken into consideration.

PE - Assets used - As regards assets, all belong to the main enterprise as PE in law is not separate from it, though it is so deemed for the purpose of allocation of income to the jurisdiction where it is located. Assets used by the PE would be those of the main enterprise which are used in the functions performed by it. The capacity in which used by the enterprise is also relevant, whether as an owner, lessee or a member of cost contribution agreement, because income earned from the third parties will include a return from the assets used. Income would be greater from an owned than from the leased asset as in the latter there is an outgo by way of lease rent. The asset to the extent used by the PE in performing functions, accordingly the profit, is attributed to the PE. Such attributed asset are also taken into account in the comparability analysis.

The nature of the assets and the conditions under which used are also relevant.

The analysis would also determine whether the assets are created by the activities of the enterprise itself or acquired from another enterprise. The attribution of assets and their classification would affect attribution of profit and the attribution of capital and debt to the PE.

PE - Risks assumed

PE may be considered as assuming risks (even though legally the enterprise as a whole bears the risks) which are inherent in, or created by, the PE's own functions (*i.e.* , for the purpose of the PE) or relating to directly to those activities. Since the PE is not a separate entity in the sense of a subsidiary from the parent company, the entire risks and capital belongs to enterprise as a whole. The risks associated with the functions performed by the PE are attributed to it. Since capital follows risks, it is required to be attributed to the PE to support the associated risks. Assumption of risks, therefore, influences the attribution of the profits and also the attribution of the capital and interest bearing debt. The division of risks is to be deduced from the conduct of the PE and the other parts of the enterprise and the economic principles that govern the relationship between the independent parties. This is done by comparing what similar independent parties would do, by examining internal practices, or by examining internal data or documentation showing how attribution of risks was done.

PE - Capital attribution

Under the authorized OECD approach, the PE is treated as having an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes. Assets are attributed to the PE based on where the economic ownership of the assets lies and where the risks associated with those assets, or the attempted creation of the assets, are assumed. Capital and risks cannot be segregated. After the factual and functional analysis has attributed the assets and the risks with the value of the assets having been determined and the risk measured, what is required to be determined how much of the "free" capital is needed to cover those assets and support the risks. Free capital means an investment which does not give rise to an investment return that is deductible for tax purposes under the rules of the host country of the PE Under the authorized OECD approach the PE needs for tax purposes to have attributed to it an arm's length amount of "free" capital, irrespective of whether such capital is formally allotted to the PE. There are various approaches to determine it, as suggested in the OECD Draft Discussion on the Attribution (August, 2004)—

- The Capital Allocation approach;
- Economic Capital Allocation approach, in banking context ;
- Thin Capitalization approach;
- Safe harbour approach - Quasi thin capitalization/regulatory minimum capital approach ;
- Other methods, especially in the context of insurance sector.

The capital allocation approach seeks to allocate an enterprise's free capital to PE in accordance with the attribution of assets owned and risks assumed under this approach free capital is allocated on the basis of the proportion of assets and risks attributed to the PE by the functional analysis. So if the PE has 10 % of the enterprise's assets and/or risks it will have attributed to it 10% of the enterprise's free capital (para 116 OECD Discussion on Attribution of profits, August 2004).

The thin capitalization approach would be to require that the PE has the same amount of free capital as would an independent enterprise carrying on the same or similar activities in the host country of the PE by undertaking a comparability analysis of such independent enterprises. The functional and factual analysis would identify the assets and risks to be attributed to the PE and this would determine the amount of funding *per se* (*i.e.*, without

distinguishing between debt and free capital) that would be required by the PE. The next stage would be to determine the allocation of the funding into interest bearing debt and free capital.

Every approach has its own weakness and strength. Which is more appropriate depends on the facts and circumstances of a case. The attribution of the capital, however, be carried out in accordance with the arm's length principle to ensure that a fair and appropriate amount of profits is allocated to the PE.

PE - Attribution of profits

The attribution of profits to a PE of an enterprise will follow from—

- The attribution of functions, assets and risks between it and the rest of the enterprise of which it is a part based on functional and factual analysis, taking into account of the dealings that can appropriately be recognized.
- The attribution of capital based on assets and risks attributed to the PE.
 - The pricing on arm's length basis of dealings that can appropriately be recognized, having passed the threshold test. (Before a dealing is accepted as a equivalent to a transaction that would have taken place between independent enterprises acting at arm's length, a threshold test to be passed. A functional and factual analysis will determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and the another part of the enterprise)
- The recognition of the transactions between the enterprise and independent third parties that are attributed to the PE (subject to, for example, any displacement of third party borrowings as a result of the attribution of capital to the PE's assets and risk).
- The determination of comparability between dealings and uncontrolled transactions, establishing by applying the Guidelines (OECD) comparability factors directly (characteristics of property and services, functional analysis, economic circumstances and business strategies) or by analogy (contractual terms) in light of the particular factual circumstances of the PE.
- The determination of an arm's length compensation for the functions that the PE performs, taking into account the assets and risks attributed to the PE achieved by applying by analogy the OECD Guidelines traditional transactions methods, or, where such methods cannot be applied reliably, the transactional profit methods.

[See para 70 of the OECD discussion Draft on the Attribution of Profits (August, 2004)]

A transaction in normal sense means an agreement requiring more than one party. There cannot be transaction between an enterprise and its PE because the PE is not in fact legally or economically separate from the rest of the enterprise. Any dealings between them have no legal consequence. But for the purposes of transfer pricing, the dealing can be taken equivalent to transaction as if between two associated enterprises having legal consequences, if it takes place under the normal commercial conditions. The dealing will be recognized only if it relates to a real and identifiable event, e.g., the physical transfer of stock-in-trade, the provision of services, use of the intangible assets, a change in which a part of the enterprise is using a capital asset, transfer of a financial asset etc. Whether such an event has occurred and to be taken internal dealing of economic significance, a functional analysis is undertaken by examining accounting record and contemporaneous documentation. That examination would reveal the economic reality of the dealing, i.e., whether it has transferred economically significant risks, responsibilities and benefits.

Morgan Stanley case

In *Morgan Stanley* case [[292 ITR 416](#) (SC)], an Indian company [Morgan Stanley Advantages Services Pvt. Ltd. ("MSAS")] entered into an agreement with its US parent company, Morgan Stanley and company ("MSCo") for providing certain Support Services to MSCo. MSCo outsourced some of its activities to MSAS. A question arose whether the US company had a PE in India and if so, the amount of profits attributable to such PE. The Supreme Court held that since the Indian company was engaged in supporting the front office functions of the US company and was performing in India only back office functions, it was not a PE of the US company in term of article 5(1) of the DTAA. MSCo however, rendered services to MSAS through its employees who had been sent on deputation. There was, therefore, a service PE in terms of article 5(2)(i).

As regards attribution of profits in terms of article 7, the Supreme Court held that there is no need for attribution of further profits where the transactions between the PE and the foreign company was at arm's length, provided the

associated enterprise (that also constitutes a PE) has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The Supreme Court observed that the situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits and that would depend on the functional and factual analysis to be undertaken in each case. Lastly, it may be added that taxing corporates on the basis of the concept of economic nexus is an important feature of attributable profits (profits attributable to PE).

Cudd Pressure Control Inc. case

In *Cudd Pressure Control Inc. v. The Queen* (98 DTC 660) (95 DTC 559), the Canadian branch of a US based company was denied a deduction for notional rent for the use of certain specialized equipment owned by the head office. Cudd was a US based corporation providing technical services to the oil industry. During 1985, the company was engaged by Mobil Oil to provide 'snubbing services' on a drilling located off the east coast of Canada. The services involved the use of 'snubbing units', sophisticated high pressure equipment used to control or repair oil wells. Cudd owned the only snubbing unit in the world and won the contract on that basis. There was no dispute that Cudd was carrying on business through permanent establishment (the branch) in Canada. In coming to the branch profits, Cudd included the amounts billed to Mobil Oil and deducted direct expenses plus a notional rent of approximately \$ 2.5 million for the use of the snubbing units. The rent was intended to reflect the fair market charge for the use of the equipment by the Canadian branch.

The Tax Court and the majority of the Federal Court of Appeal denied the deduction of notional rent on the basis that no rent had been paid to anyone and there was no obligation to pay it. The court held that as the notional rent was neither an 'expense' nor 'incurred' by the head office and the tax treaty could not be construed to permit a non-resident to deduct amounts which were unavailable to Canadian residents in computing their business income, it was not deductible. Instead the court considered that, under the circumstances, a more reasonable hypothesis than renting the unit would be that the branch would purchase a unit from its head office and therefore allowed capital cost allowance in lieu of the notional rent.

However, Mr. Justice McDonald of the Federal Court of Appeal, in a separate judgment, opined that a permanent establishment must calculate its profits under the fiction that it was an independent enterprise and it may deduct expenses, which may be fictional, that are allocable to permanent establishment.

This case, highlights the distinction between a branch and a subsidiary.

It also highlights that the permanent establishment may be taken as a separate and independent from its head office and there could be transaction between the two as the court had observed that the reasonable hypothesis would be that branch purchase the unit from the head office. The majority opinion was given in the context of the Canadian domestic law which did not permit such deduction. The minority opinion of Justice McDonald appears more relevant when he observed that the deduction of notional expenses would be allowed under the treaty even though such expenses are disallowed under the Canadian tax laws.

Rectification of accounts

The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect properly income which the establishment would have earned if it were an independent enterprise dealing with its head office. Its application to the allocation of profits presupposes that the domestic legislation authorises determination of the basis of arm's length principle. Section 92 of the Indian Income-tax Act, 1961 proclaims the concept of arm's length.

Rectification according to arm's length principle may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle and profits have thus been diverted from PE to the head office or *vice versa* (see paragraph 13 of the OECD Commentary on Article 7).

Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises have been those which could have been made between independent enterprises, then that other State shall make an appropriate

adjustment to the amount of tax charged therein on those profits (*see* article 9). Because both the set up are controlled by one entity, the arm's length concept is likely to be ignored or abused by manipulating :

1. Pricing of goods or services (Transfer pricing);
2. Payments as royalty or interest, and
3. Other payments

Paragraph 2 deals with the first; and paragraph 3, the remaining two.

Business profits - Transfer pricing (arms length principle)Business profits - Transfer pricing (arms length principle)

13.11 Paragraph 2 provides the rules for attribution of business profits to a permanent establishment. The language incorporates the arm's length standard for the purpose of determining the attributable profits. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or under the same effective control are dealt with in Article 9. Such treatment is commonly referred to as transfer pricing. Criteria used in attributing profits to a permanent establishment (under article 7) and allocation of profits from transactions between enterprises under common control [under Article (9)], appear to be the same. The two Articles incorporate a number of directives, without laying down precise rules for dealing with every kind of problem. It is, therefore, necessary at this stage to have preliminary introduction to the concept of transfer pricing, which is discussed in detail later in chapter 15. Transfer pricing usually refers to the value attached to transfer of goods, services, and, technology between related entities such as parent and subsidiary corporations and also between the parties which are controlled by a common entity. Its essence is that the pricing is not set by an independent transferor and transferee in arm's length transaction, but it is within the discretion of a single enterprise. The effect of such a device is that the profit properly attributable to one jurisdiction is shifted to another jurisdiction. This is done through excessive management fees, royalties for the use of technology, overinvoicing of the imported components, or underinvoicing exports. Where there is substantial local participation, profit are withdrawn through transfer pricing abuses so that very little is left for the local participation to share. The abuses could be curbed in three ways. One, by establishing an arm's length transfer price which requires an enquiry what unrelated parties, not under common control, would do in similar circumstances. It is an attempt to establish the price that would prevail in the market place. Second, apportionment of the overall profit of the enterprise *i.e.*, establishing a fair or proper division of its global profits without regard for how the market place would operate; or notional export price *i.e.*, to fix the notional price as a predetermined portion of the total value of the finished for which the primary commodities are exported (*see* paragraph 4 of the article). Third, taxing intra-firm transfer *i.e.*, taxing royalty payments, income attributable to services performed within the host country over relatively long period of time and income from the sale of goods if the sales are attributable to a "permanent establishment" in the host country. Non-deductibility of the intra-firm payments may discourage setting price artificially (*see* paragraph 3 of the article). The net impact of denying deductibility is that the amount of intra-firm payment is subject to regular corporate tax in the country in which the payer is a resident. Interest and royalty payments to affiliated enterprises may not be deductible unless the payer establishes that the payments are consistent with normal commercial practices. The Indian Income-tax Act, 1961 prohibits deduction in computing the income, in respect of any interest, royalty, fee for technical services or other sum chargeable under the Act, which are payable outside India, on which tax has not been paid or deducted at source. The subject is discussed in detail in Chapter 15.

Head Office Expenditure not allowed deductionHead Office Expenditure not allowed deduction

13.11-1 Paragraph 3 of the UN Model also provides that no deduction of expenses shall be allowed or no account taken, in respect of the amounts, if any paid (otherwise than reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or by way of interest on money's lent to the permanent establishment (banking company is an exception). (The OECD Model does not so provide. However, according to the Commentary accompanying it, royalty and interest payment to the head office should not be allowed to be deducted). Such a prohibition aims at preventing shifting profits from high-rate countries to other destination. Similarly high management fee which could also be used for relocating the profits to beneficial locations are not allowed deductions, in some treaties.

Branch and subsidiary company - Distinction as regards deductibility of expenses

13.11-2 Notional deductions are not allowed for some intra-company transactions. Paragraph 3 prohibits allowance of deduction in respect of amount paid (except paid as reimbursement of actual expenses) to head office or any of its other offices by way of -

- royalties, fees, or, any other similar payments;
- commission for specific services performed or for management; or
- interest on money lent to permanent establishment

Similarly, no account is taken in the computation of profits in respect of the amounts received by the PE from the Head office on account of the above.

Thus, the determination of profit of the PE is substantially different from the process which is required in a subsidiary/parent situation. The amounts in respect of the above are taken into account in the computation of profits as receipt or expenditure, as the case may be. Such a process reflects economic realities. Branch profit determination provides no allowance for intra-company profit attributable to the values provided by the parent company unless actual costs have been incurred [*Cudd Pressure Control Inc. v. The Queen* 98 DTC 6630 (FCA)]. Allowance is only permissible, if it is reimbursement of the actual expenses.

Business profits - Maintenance of separate accounts by permanent establishment

13.12 Under the provisions of the Indian Companies Act, 1956, every foreign company has to maintain its books of account relating to Indian business in the manner provided in section 209 thereof. In each calendar year it has to file its world account. It has also to file a list of places of business establishments in India. It is also under obligation under section 594 to deliver three copies of its world account to the Registrar of the company. Three copies of balance sheets of the Indian business accounts duly audited have also to be filed within nine months of the close of the financial year. The Indian account has to be drawn in Indian rupees. Thus the profit and loss account of the Indian business has to be prepared separately by a foreign company, as per requirement of the Indian Companies Act, 1956. In exercise of the powers conferred by the proviso to sub-section (1) of section 594 of that Act, the Central Government has directed that requirements of clause (a) of sub-section (1) shall apply to a foreign company having a share capital subject to exceptions and modifications specified below, namely:

- (i) A foreign company shall, in respect of its Indian business, submit to the appropriate Registrar in triplicate its balance sheet and profit and loss account in such form containing such particulars and including or having annexed thereto such documents as under the provisions of the Act it would, if it had been a company within the meaning of the Act, have been required to make out and lay before the company in general meeting;
- (ii) The working capital earmarked for its branch, if any, shall be shown in the balance sheet;
- (iii) The profit and loss account in respect of its Indian business shall disclose the net profit or the loss for the year transferred to its principal office in the country of its incorporation;
- (iv) The Government shall have the authority, when there is a difficulty in reconciling the balance sheet and the profit and loss account with clause (i) with balance sheet and profit and loss account filed by that company in the country of its incorporation, to seek clarification or demand the making of the balance sheet and the profit and loss account filed in that country, as far as practicable, in such form as it would, if it had been a company within the meaning of the Act, have been required to make out and lay before the company in a general meeting, and the foreign company shall be bound to make such clarification or comply with such demand as the case may be.

The foreign company has to disclose in its profit and loss account the amount payable as income-tax in India. After arriving at the gross profit of the company net profit has to be calculated after deductions of various items of expenditure as well as allowances. It has to make calculation of the profit attributable to its Indian business separately and independently. It has to furnish a balance-sheet and profit and loss account in respect of the Indian business to the appropriate authority. Accordingly, it has to calculate its Indian profits separately and disclose the net profit arising in India which has to be remitted to the foreign country. In case of a foreign company for which there is no double taxation agreement, the profit is taxable only if there is a business connection between it and India.

Business profits - Determination in India Business profits - Determination in India

13.13 If once an establishment is conceded to be a permanent establishment, the other part of the regulations apply and the tax is imposed only on so much of profit as is attributable to that establishment. Nothing much is left by way of discretion to the taxing authorities to decide the basis on which attribution of income is to be made, other than those provided in the tax agreements. This is done in two ways :

1. Determination of income as if the establishment is an independent enterprise and thereafter computation of profits after allowing deductions, expenses etc., which have been incurred for the purposes of the business of that establishment subject to the provisions of the relevant agreement, and in accordance with the domestic law;
2. Apportionment method, if its customary in a Contracting State.

Paragraph 3 of article 7 provides for 1; while paragraph 4, for 2.

Business profits - Computation of Business profits - Computation of

13.13-1 For computation of total income of a taxpayer, the Indian Income-tax Act, 1961 has classified income under five heads, *viz.*, Salaries; Income from house property; Profits and gains of business or profession; Capital gains; and, Income from other sources. Different rules govern computation of income falling under the specific head. Under the tax agreements, income is classified almost similarly and given different treatment with regard not only to jurisdiction of the resident or the source state, but also to computation. Various reliefs have been given to nationals or residents or enterprises of the Contracting States. Articles which deal with profits of an enterprise are 7, 8 and 9. Special rules are provided in article 7 for computation of business profits. Article 8 deals with shipping, inland waterways transport and air transport. Article 9 deals with associated enterprises. Incomes which fall under the head "Income from other sources" under the Indian Income-tax Act, are the subject-matter of different articles of the tax agreements. Dividends (article 10), interest (article 11), royalties (article 12) are taxable at a concessional rates. Article 13 contains rules of computation of capital gains. Article 20 exempts from tax payments received by student and apprentices in certain circumstances, altogether. Total income of a resident of another Contracting State will have to be computed in India after giving these benefits. Tax agreements affect the tax treatment of permanent establishment to a certain extent. Article 7 limits the quantum of taxable income. Computation of that income for the purpose of determination of the tax liability of the establishment is done in accordance with the provisions of the domestic law which is applicable to domestic entities. All provisions of Indian Income-tax Act, 1961 are applicable, including provisions relating to depreciation, investment allowances, deductible expenses, carry forward and set off losses etc. deviation, however is made which relates to:—

- a. Taxability of income which could be attributed to permanent establishment;
- b. Deductibility of expenses which could be attributed to such permanent establishment;
- c. Non-deductibility of certain payments, such as royalties and interest;
- d. Other modifications in the light of specific treaty provisions;
- e. Dealing at arm's length, treating permanent establishment as if it were completely independent of the enterprise of which it is a permanent establishment.

The material provisions in regard to the computation of income under the Indian Income-tax Act under the head "Profits and gains of business or profession" are to be found in sections 28, 29 and 145. These are discussed later.

There are many provisions in the said Income-tax Act which are specially applicable to foreign companies. Likewise there are very many provisions which apply to Indian companies only. Section 44D contains provisions for computing income by way of royalty etc., in case of foreign companies. Section 44BB provides provision for computation of profits in the case of non-residents engaged in the business of supplying plant and machinery etc., for the extraction/production of mineral oils. Likewise, there are special provisions for computation of profits for the operation of aircraft (section 44BBA), profits from shipping business (section 44B), computation of profits from turnkey power projects (section 44BBB), deductions of head office expenses (section 44C). There are also special exemptions available to a foreign company under sections 10(6A) and 10(6B). Special concessions have been given to non-resident sportsmen. Section 115A contains special provisions for tax on dividends, interest, royalties and technical fees in the case of a foreign company. Thus a large number of concessions are given to a foreign company which are not available to an Indian company. An Indian company pays tax on its total world income whereas a foreign company is liable only in respect of income which accrues or arises in India. There are

also other various concessions. There are provisions which are not applicable to foreign companies. For example, sections 115-O, 115B and 115Q are applicable to only to domestic companies. Surcharge imposed by the annual Finance Act is payable only by the domestic companies. There are similarly several provisions which have been made applicable to Indian companies alone.

A foreign enterprise is liable to be taxed on so much of its business profit as is attributable to its permanent establishment in India. The quantum of taxable income is thus limited to so much as is attributable to that establishment. After that amount having been arrived at, net profit has to be calculated after deductions of various items of expenditure as well as allowances. This has to be done as per provisions of the Indian Income-tax Act, unless a foreign company is specifically excluded - *Niko Resources Limited v. CIT* [1998] 234 ITR 828 (AAR); *P. No. 14 of 1997, In re* [1998] 234 ITR 335 (AAR). In both the cases the applicability of section 115JA about the minimum alternate tax on zero tax companies was upheld with respect to foreign enterprise. In *Dy. CIT v. Mitubishi Heavy Industries Ltd.* [1998] 61 TTJ (Delhi) 656, the Tribunal held that disallowance of expenses/payments under section 40A(3), section 40A(12), section 37(2A), and section 43B could be made.

In the above cases of advance rulings (234 ITR), the Authority held that section 115JA of the Indian Income-tax Act, 1961 is applicable to a foreign company. That section provides that the total income of a company would be deemed to be 30% of the book profit, if the computed income falls short of it. It is notwithstanding anything contained in any other provisions of the Act. Reasons given are:—

1. There is no reason to presume that the Legislature did not intend the provision to apply to an assessee which is foreign company;
2. Under the provisions of the Companies Act, every foreign company has to maintain the books of account relating to the Indian business in the manner provided in section 209 and in each calendar year has to file its world account;
3. The foreign company is also under the obligation under section 594 of the Companies Act to deliver three copies of its world account;
4. The fact that the applicant company is a tax resident of the Netherlands and has got a permanent establishment in India does not make any difference to the position in law;
5. The provisions of section 115JA apply "notwithstanding anything contained in any other provisions of the Act".

There could be another view that provisions of section 115JA are not applicable and the above reasons not sustainable. Those provisions are popularly referred to "Minimum Alternate Tax" provisions to be applied to "zero tax companies". The subject-matter has been discussed in somewhat details in Chapter 37 (paras 37.4 to 37.10). Zero tax companies are those which structure their business around plethora of incentive provisions so that they need not have to pay any tax. The Government may desire investment in a specific direction or industry or in an area, for consideration other than revenue. For that matter it provides tax incentives. Such incentives are popularly known as "tax expenditure". While taxation can be used to achieve goals similar to those of direct public expenditure, accounting for the costs and benefits of tax measures, is often less rigorous. Many Governments produce tax expenditure accounts which show the revenues foregone as a result of tax privileges. Section 115JA curtails those tax privileges under certain conditions by restricting the extent of incentives. The incentives as provided under the Act (mainly under Chapter VIA of the Income-tax Act, under the heading "C - Deductions in respect of certain incomes", such as, sections 80H, 80HH, 80HHA, 80HHB, 80HHC etc.) are deducted while computing the total income. Deductions as provided in sections 30 to 43D are also made. The difference between the two deductions is that while the latter are allowed because they relate to the expenditure which has been incurred or laid out for the purposes of business and have, therefore, to be allowed to arrive at the true and real profits; the former, as incentive. Section 115JA relates to deductions by way of incentives. In the case before the Authority deduction related to depreciation and not to the incentive provisions.

The Indian Companies Act, 1956 deals with the law relating to companies. The expression "company" has been defined in section 3, to mean a company formed and registered under the Act. It does not include a foreign company. The provisions of the Act are, therefore, applicable to the Indian companies. Foreign companies, however, are under obligation to furnish some documents or disclose certain information as regards to the establishment of place of business in India, under Part XI of the Act (sections 591 to 608). Such obligations do not render them liable to other provisions. Making of the account is for a limited purpose, as prescribed in that Part.

The concept of book profit as relevant to the Indian companies may not be relevant. Section 115JA could not, therefore be applicable.

Further, the limited application of the Companies Act relates to foreign companies which have established a "place of business within India". The expression "establish a place of business" is not synonymous with the expression "permanent establishment" as defined in article 5. A foreign company may have a permanent establishment in terms of that definition, but may not be said to have established a place of business or *vice versa*. Business income without permanent establishment cannot be taxed in India. Even when it is taxed, income is computed by virtue of a deeming provision of article 7. Whole of the profits of the foreign company is not taxable; only so much as is attributable to the permanent establishment. Attributable profit is determined by the apportionment of the total profits of the company or is done on a hypothesis that the profits which the permanent establishment might be expected to make as if it were a distinct and separate enterprise. Article 7(3) requires that in determination of the profits, expenses which are incurred for the purposes of the business of the permanent establishment, wherever incurred, shall be allowed as deduction. It also contains a very important restriction, that, in the process, only such expenses can be allowed "as are allowed under the domestic law of the Contracting State in which the permanent establishment is situated" (see *Ericsson Telephone Corpn. v. CIT* [1997] [90 Taxman 144](#) (AAR- New Delhi)). Thus, the article deems what income is taxable and provides for procedure for its computation. Section 115JA is neither a charging, nor a computation section. It cannot have the deeming effect upon the deeming provision of article 7. When once an attributable income has been deemed by that article and figure arrived at and tax determined there cannot be further deeming to enhance the tax so determined. Deeming over deeming is not contemplated. Section 115JA is, therefore, not applicable. The expression "notwithstanding" does not override the clear mandate of the DTA read with the Act (*see* para 37.8).

Business profits - Determination, apportionment method

13.14 Paragraph 4 of the article provides for determination of profits to be attributed to the permanent establishment on the basis of an apportionment of the total profits of an enterprise to its various parts. It is subject to two conditions; (1) if it has been customary in a Contracting state to so determine; and, (2) the result of such determination shall be in accordance with the principles contained in article 7. The principle which controls determination is contained in paragraphs 1 and 2. It is : the profits which the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same and similar activities under the same and similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. It is an arm's length approach. Apportionment method should follow this principle, though determination of the profit is alternative to the determination by the arm's length method. The latter seeks to approximate the market. The object of the apportionment method is to establish the division of the overall profits notwithstanding how the open market operates. It is not to determine the market price for an inter-company transactions, but to establish a fair or proper division of the world profits. Various modes for that matter are suggested; total sales, or total payroll and sales, and, payroll within taxing jurisdiction. Profits could be apportioned under a formula that averages the three ratios of local sales, assets and labour costs to their world wide equivalents. Once a method is chosen and adopted, it would be operative for the determination of the profits as attributable to the permanent establishment, year after year unless there is good and sufficient reason to the contrary (paragraph 5 of the article 7).

The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated or a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the certain criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from varying criteria used to determine what is the correct proportion of the total profits (*see* paragraph 27 of the OECD Commentary on Article 7). Criteria commonly used can be grouped into three main categories which are based on-

- (1) on receipts of the enterprise (based on turnover or on commission);
- (2) its expenses (based on wages);
- (3) its capital structure (based on proportion of the total working capital of the enterprise allocated to each branch or part).

Appropriateness of any particular method depends on the circumstances to which it is applied.

The OECD Commentary gives illustration of the appropriateness of the applicability of the particular method :

- *Turnover or commission method* - In case of enterprises providing services or producing proprietary articles with high profit margin, net profit will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned.
- *Expenses method* - In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related to more closely to expenses.
- *Capital structure method* - In the case of banking and financial concerns the proportion of the total working capital may be the most relevant criterion.

The Commentary further says:

"It is considered that the general aim of any method involving apportionment of the total profits ought to be to produce figures of taxable profits that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all known facts seems most likely to produce that result."

Business profits - Apportionment method yields predictable result

13.14-1 Since the apportionment method does not depend upon variables which are difficult to evaluate as in the case of arm's length method, it yields predictable result. It requires an established formula. It is, therefore, certain and simple. Its certainty, simplicity and predictability have led its world wide acceptance in preference to arm's length method. It is for this reason, perhaps, the OECD Model Tax Convention and UN Tax Treaty Guidelines include the apportionment method as acceptable way of determining the profit. It is, however, also beset with problems. It may lead to conflicting and competitive claims of the respective countries. Absence of uniform apportionment formula each country tends to resort to which is more favourable to it. For example, if a country is relatively high wage country, it would prefer which is dependent upon labour cost. Even if the countries agree to one uniform formula, still there could be conflict in interpreting various variables; for instance, about total sales, total profits, allocation of sales to the respective country. A sale has many stages to go through before it could be said having been completed, *viz.*, the place of entering into a contract, the place of handing over the object, the place of production of goods, etc. For allocation of sales, which stage should have prevalence over the other is a matter of interpretation, which may lead to conflict between the countries. Conflict may concentrate on the passage of the title or on substantial connection test or on the ultimate use test.

Electronic business - Attribution of profits

13.14A There are no rules on attribution of income derived from electronic commerce. If a non-resident is deemed to have business presence in a country through a branch or a dependent agent, the amount of income corresponding to the business operations exercised within that country is attributable to the PE.

Income derived by non-resident from the sale of tangible goods produced abroad is not subject to taxation because the entire productive activity was undertaken there. Mode of placing orders for such goods is of no relevance. It may be done through telephone, fax or post. If done through electronic media, the nature of transaction would not change. Electronic transactions concerning tangible goods are not treated differently from done traditionally. Sale without maintaining an economic presence (PE) would not give rise to taxation. When the sale of tangible goods delivery of which could only be made physically is effectuated through PE, it is taxable. In the case of sale of intangible goods effected not through the PE but done direct through internet there is also no difficulty as it would be taxed as the income of the PE. If there is a PE, there is no difference whether the product is sold through or direct without the assistance of the PE. The criterion for taxation being the existence of PE, there is no distinction in a domestic law based on the character of the electronic transaction. A sale that is concluded through internet is treated in the same way as a sale made with traditional means of communication. Digitised product downloaded is like goods physically shipped.

Tax treatment of the payments to non-residents payees for the acquisition of software presents a difficulty; whether it is to be taken as sale to which article 7 applies or as rentals to which article 12 applies. They are not taken as rentals when they refer to the acquisition of the software -

- as goods for resale;
- which is mass produced in a uniform manner and offered in the market to anyone interested.

There is no difference in regard to business being done traditionally and electronically; the internet being used to make supply chain more efficiently. The goods are still delivered from the supplier to the customer. Income corresponding to business operations exercised in a state is attributed to the PE in that state for the purposes of the domestic law, in which case costs and expenditure incurred in that state are deductible, including depreciation in respect of assets located in that state. As regards sales through local dependent agent, taxable profit is subject to imputation in the manner already discussed in paragraph 13.14 and 13.4-1. The attribution principle as applied to conventional business transactions also applies to electronic business, as already discussed.

Difficulty would arise in relation to income derived from the supply of intangibles; digitised goods or services. Digitisation has eliminated the need of for physical delivery of certain goods and services. Taxation issues surrounding them could not be easily resolved.

For that matter it has first to be ascertained whether the transaction is a sale of rights/royalties/services or of goods.

It has to be seen whether electronically transfer of digitised information such as software, books, movies and images has given to the purchaser of the digitised item (say a computer game) a right to use the single copy or the right to reproduce the software for others to use.

Business profits - Taxation India's approach to tax treatyBusiness profits - Taxation India's approach to tax treaty

13.15 India favours UN Model and the concept of "force of attraction" rule. That Model also incorporates the OECD rule *i.e.*, the attribution rule. Thus, India asserts the right of the source country to assess not merely the profits attributable to the permanent establishment, but also profits from sales of goods or merchandise of the same or similar kind as those sold through permanent establishment, and the profits of the other business activities carried on of the same or similar kind as those effected through the permanent establishment. In order to prevent the abuse of the transfer pricing, the profit is determined on the arm's length doctrine and by prohibiting deductions by way of royalty, interest and other payments to the head office. The treaties with Belgium, Czech Republic, Hungary, Norway, Poland and Slovak Republic follow the UN Model. "Force of attraction" rule is found included in the treaty with Australia, Canada, Denmark, Finland, New Zealand, and Sweden. The treaty with Japan, Netherlands, and the UK adopts the UN approach to allow expenses. Treaty with Russia, Switzerland, Ukraine and the UK uses the phrase "directly or indirectly attributable to the permanent establishment". Such a phrase is the recognition of the "force of attraction" doctrine.

Business profits - Treaty with AustraliaBusiness profits - Treaty with Australia

13.15-1 The article follows the UN Model closely. It clarifies no profit shall be attributed to permanent establishment by reason of the mere purchase by that establishment of goods or merchandise for the enterprise. Paragraph 4 (customary practices to determine the profits on the basis of apportionment of the total profits) is omitted. Paragraph 5 of the treaty, however, provides that in case correct amount of profits is incapable of determination, nothing shall affect the application of any law of the Contracting State relating to the determination of the tax liability of a person. There is an additional paragraph which preserves the application of domestic laws relating to insurance business, allowing the tax authorities to estimate the tax liability in the absence of adequate information. There is also a provision allowing the tax authorities to look through a trust which carries on business through permanent establishment and tax a beneficiary who is entitled to a share of the profit, on his share of the income of the permanent establishment.

Business profits - Treaty with CanadaBusiness profits - Treaty with Canada

13.15-2 The article follows the UN Model. It is clarified in paragraph 5 that no profits shall be attributed to permanent establishment by reason of the purchase by that establishment of goods or merchandise for the enterprise.

Business profits - Treaty with FranceBusiness profits - Treaty with France

13.15-3 The treaty principally follows the OECD Model. It does not contain the force of attraction rule. No profits shall be attributed to permanent establishment by reason of mere purchase by the establishment of goods or merchandise for the enterprise. Where deductions for executive and general administrative expenses are restricted by the laws of the State in which the permanent establishment is situated, but that restriction is overridden by any

treaty or protocol signed after 1st January, 1990 by that State and a third State which is member of the OECD, then a similar overriding, if requested by the other State, would apply.

Such restriction of deduction for executive and general administrative expenses shall in no case come to less than that which is allowable under the Indian Income-tax Act, as on 29th September, 1992. The Protocol of Signature also provided the following:—

- ◆ If the rule of force of attraction is provided in the India's new tax treaty United Kingdom and Federal Republic of Germany, that rule shall also apply to the present treaty.
- ◆ Where the enterprise sells goods or merchandise or carries on business through the permanent establishment, the profit of the establishment is not determined on the basis of the total amount received by the enterprise. It is to be determined on the basis of the remuneration which is attributable to the actual activity of the permanent establishment for such sales or business.
- ◆ In the case of contracts for the survey, supply, installation or construction of industrial, commercial or scientific equipment or premises, or public works, the profits of the permanent establishment shall not be determined on the basis of the total amount of the contract. It shall be determined only on the basis of that part of the contract which is effectively carried out by the permanent establishment.
- ◆ No profits shall be attributed to permanent establishment by reason of the facilitation of the conclusion of foreign trade or loan agreements or the mere signing thereof.

Business profits - Treaty with Germany Business profits - Treaty with Germany

13.15-4 The treaty follows the OECD Model. It does not contain the force of attraction rule.

Business profits - Treaty with Japan Business profits - Treaty with Japan

13.15-5 The treaty does not specifically provide for the force of attraction rule. The attribution rule of the OECD Model is modified. Profit as is indirectly attributable is also taxable. It was, however, clarified in the Protocol of Signature that the profits "directly or indirectly attributable to the permanent establishment" mean so much of the profits arising from transactions in which the permanent establishment has been involved as is appropriate to the part played by the permanent establishment, and also that profit shall be regarded as attributable even when the contract or the order relating to the sale or provision of the goods or services is made or placed with the overseas head office of the enterprise rather than with the permanent establishment.

As regards deductibility of expenses, the Protocol of Signature provides

1. Executive and general administrative expenses are to be allowed in accordance with the domestic law of India, but such deduction in no case be less than what were allowable under the Indian Income-tax Act as effective on the date of signing the Convention;
2. No deduction shall be allowed in respect of the amount paid or charged (other than the reimbursement of the actual expenses) by a permanent establishment of an enterprise to its head office or the other offices, by way of :
 - a. royalties, fees or other similar payments in return for the use of patents or other rights, or for the use of know-how;
 - b. Commission or other charges, for specific services performed or for the management; and

Interest on money lent to the permanent establishment except where the enterprise is a banking institution.

Business profits - Treaty with United Kingdom Business profits - Treaty with United Kingdom

13.15-6 The treaty does not contain the force of attraction rule.

- ◆ Profits indirectly attributable to permanent establishment is also taxable. Such profit arises where the permanent establishment takes an active part in negotiating or concluding or fulfilling contracts entered into by the enterprise. It is determined in the ratio of the profit arising out of those transactions and of the profit of the enterprise. For ascertaining the active part, the contracting States shall take into consideration all relevant circumstances. The fact that a contract or order relating to purchase or provisions of goods or services was negotiated or placed with the head office, rather than with the permanent establishment, shall not preclude them from determining that the permanent establishment did take place an active part. (Exchange of dated the 25th January, 1993).

- ◆·Expenses which are incurred for the purposes of the business of the permanent establishment are allowed deductions. It is subject to the limitations of the domestic law of the treaty partners. If such restrictions are relaxed or overridden in any other treaty with one of the Contracting States and the third state which is a member of the OECD or in a comparable state of development, the terms of the DTA will be modified accordingly if a request is made by the concerned Contracting State.
- ◆·As regards allowability of certain expenses incurred on account of payment to the head office, similar provision exists as mentioned in 2 above under "treaty with Japan".
- ◆·Paragraph 6 of the OECD Model does not exist.

Business profits - Treaty with USA Business profits - Treaty with USA

13.15-7 The treaty defines the expression "business profit" to mean income derived from any trade or business including income from the furnishing of services other than included services (as defined article 12 of the treaty) and including income from the rental of tangible personal property other than the property described in paragraph (3)(a) of article 12. The treaty is specific as regards profits attributable to permanent establishment. It is to include only the profits derived from the assets and the activities of the permanent establishment. The treaty generally follows the UN Model. It contains the rule of force of attraction.

Paragraph 3, provides that in determining the business profits of a PE, deductions shall be allowed not only for the expenses incurred for the purpose of the PE but also a reasonable allocation of executive and general administrative expenses, research and development expenses, interest and other expenses incurred for the purpose of the enterprise as a whole (or the part thereof which includes the PE) whether incurred in the State in which the PE is situated or elsewhere. It does not permit a deduction for expenses charged to a PE by any other unit of the enterprise, deduction for royalty or fee deemed to have been paid to the head office. Paragraph 4 provides that no business profits can be attributed to a PE by reason of mere purchase by the PE of goods or merchandise for the enterprise. Paragraph 5 provides that profits attributable to PE shall include only profits derived from its assets and activities. Paragraph 6 provides that where profits include items of income which are dealt with separately in other articles, the provisions of those articles shall have precedence. Paragraph 7 defines the expression "business profits" as to mean income from any trade or business including income from any services other than included services as defined in article 12 and including income from the rental of tangible personal property other than the property described in paragraph 3(b) of article 12.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

BUSINESS INCOME - SHIPPING, INLAND WATERWAYS AND AIR TRANSPORT

ARTICLE 8

SHIPPING INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

ARTICLE 8A (ALTERNATIVE A)

- 1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
- 2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
- 3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour*

of the ship or boat is situated, or, if there is no such home, harbour in the Contracting State of which the operator of the ship or boat is a resident.

4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

ARTICLE 8B (ALTERNATIVE B)

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by . . . per cent. (The percentage is to be established through bilateral negotiations).

3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or if there is no such home harbour in the Contracting State of which the operator of the ship or boat is a resident.

5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

IntroductionIntroduction

14.1 Article 8 deals with business income from international transport. Its main object is to restrict the jurisdiction of the State in respect of profits arising from operation of ships or aircraft in international traffic. Where income arises, is the involved question. It cannot be said to have been done where the goods or the passengers are picked up or transported. The basic feature of the business is the service of transportation, rendered on high seas or space. The vehicle of transport *i.e.*, the ship or the aircraft, is not permanently located in any one state. The concept of permanent establishment is not applicable. Since the principle source of income is the services and not the vehicle and services are rendered, as aforesaid, on high seas or space, there is difficulty in the allocation of income. As a resolution, the commonly used methods are : (1) to apportion the receipts and expenses in some way between the countries concerned, and (2) to give sole taxing rights to the country operating the relevant ship or aircraft. Tax treaties generally adopt the second. Operating country for that purpose is taken to mean, as per OECD model or to some extent UN model, the country where the business is effectively managed. To some countries it means where the operating company is incorporated, as in the US. The concept of "effective management" is vague and incapable of preciseness as where it is exercised. Some countries may prefer the residence criterion for deciding the jurisdiction. This the commentary accompanying the OECD model article recognises.

The UN Model provides two alternatives. Alternative A reproduces the OECD Model version and Alternative B makes substantial changes from OECD version. The latter alternative suggests that the developing countries do not want to forgo even limited revenue to be derived from taxing foreign shipping enterprises as long as their own shipping industries are not fully developed. It empowers non-management state to tax appropriate part of the profits from international shipping.

Paragraphs 1 and 2 of Article 8A provide that the profits derived by an enterprise shall be taxed only in one State only, *i.e.*, where its effective management is situated, from the operation of ships or aircraft in international traffic or from the operation of boats engaged in inland waterways. The expression "international traffic" has been defined in clause (d) of paragraph 1 of Article 3. Paragraph 3 defines the expression "effective management". Paragraph 4 is an extension of paragraph 1, providing for similar rule for taxation of profits from the participation in a pool, joint business or an international operating agency.

Shipping business - Permanent establishment concept not applicableShipping business - Permanent establishment concept not applicable

14.2 The rule of establishment of a permanent establishment (article 5) and of the business carried through it (article 7) do not govern the taxation on the profits from shipping business. The rule that governs is an operative rule, which gives exclusive right to the residence country under the OECD model. The taxation presents complex problems, if carrying on business is treated at par with any other kind of business and its taxability is qualified by the provisions of articles 5 and 7 relating to business profits. Taxability on the basis of permanent establishment rules would have meant that every country would have taxed a portion of the profits of a shipping organisation, computed in accordance with its own laws, and thus, there could have been likelihood of total sum of these portions exceeding the total income of the enterprise. The possibility cannot be ruled out when an enterprise could derive all its income without ships calling at the ports of the residence country.

International transportation by ships or aircraft and not by buses or trucks etc., is covered by article 8. Business activities through buses or trucks are covered by article 7.

Profits from the operation of ship or aircraft in international traffic taxable only in the management State and not in the other State despite of the presence of a PE there. The Technical Explanation, US Model Convention, illustrates

"Thus, if a U. S. airline has ticket office in the other State, that State may not tax the airline's profits attributable to that office under Article 7. Since entities engaged in international transportation activities normally will have many permanent establishments in a number of countries, the rule avoids difficulties that would be encountered in attributing income to multiple permanent establishments if the income were covered by Article 7 (Business profits)"

Shipping business - Operative rule

14.3 The nature of the shipping business rules out the operation of the concept of permanent establishment. The in-operation is because of the absence of ship or the aircraft locating permanently in any State and the difficulty in apportioning profits amongst various permanent establishments, as aforesaid. The operating rule which governs taxation of profits is the effective management. The OECD model gives right to the State of effective management. It is irrespective of the contribution of the traffic through the other State to the income generated from such operation of ship or aircraft or the permanent establishment. Conferment of the exclusive right to the State of existence of the effective management is dictated by the consideration of the difficulty of apportionment of profits.

The place of effective management is situated may not be the State of which an enterprise operating ships or aircraft is a resident. In that case State of residence may alone tax the profits, if the treaty between the Contracting State so provides (*see* OECD Commentary on article 8, paragraph 2). The US Model Convention gives the exclusive right to the State of residence and not to the State of effective management (for example, *see* Indo-US treaty).

The paramountcy of the residence rule demands sacrifice by the developing countries to forgo their share of profits which could have belonged to them according to source rule. The UN model, therefore, suggests how the profits from the shipping should be taxed. Determination of shipping profits and allocation of such profits to various States are the two problems. The OECD model gives exclusive right to the State of effective management. The UN model suggests an alternative. The country of source, apart from the country of residence, in which the shipping activities of more than casual nature are conducted, might also impose tax. The profits to be so taxed are determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations, and the tax computed in accordance with such allocation is to be reduced to by a percentage, which is to be established through bilateral negotiations. The alternative is the method of taxing shipping profits by a country other than the country of effective management (residence countries) in which the shipping activities are conducted (source countries). As an alternative to this, there is a different method of computing the income of the source country as a percentage of source country receipts. Under the Indian Income-tax Act, 1961, sections 44B and 44BBA provide for gross basis taxation of profits of a non-resident who is engaged in the business of shipping or of operation of aircraft for carrying of passengers, livestock, mail or goods shipped at any port or from any place, in or outside India, and the payment is paid received on that account. Section 172 deals with profits of non-resident from occasional shipping business. These sections become operative when the treaty contains provisions giving right of taxation to the source State.

Article 8 of the UN model consists of two alternatives : one, (A) corresponds to the article of the OECD model; (B) represents an accommodation of the views of the developing countries that income from shipping, inland waterways transport and air transport should be shared by the country of effective management (residence country)

and the countries in which activities are conducted (source country). Shipping profits under the OECD model is taxed exclusively by the country of residence or the place of effective management of the shipping enterprise. The question of allocation of profits arises, under the UN model, if the shipping activities are more than casual. Otherwise, the profits are taxed on the residence rule (effective management).

Shipping business - Place of effective management - Situation of

14.4 Profits from the operation of ships or aircraft in international traffic or from that of boats engaged in inland waterways are taxable only in the Contracting State in which the place of effective management of the enterprise is situated. Effective management of the enterprise, as discussed in para 10.16-1 under article 4(3) means real and ultimate management. The elements of the management are; policy, management, and administration. Effective management refers to policy. Some decisions or directions are also needed for the management and administration of the day-to-day affairs of the enterprise. For that purpose directing authority may be vested in minority of directors or to somebody else who is at the scene of the business operations. They do not have final and effective authority. The exercise of the authority by them cannot be equated with controlling and the directing power, the head and the brain of the enterprise. It is situated where the functioning of such power is exercised with some degree of permanence. It is normally at the place where central management and control abides, *i.e.*, at the place where the board of directors meets and decides the matters relating to the affairs of the operation of the ships or aircraft or the boat. "Affairs" must mean which are relevant for the purpose for such operation.

The application of the concept of "effective management" under article 4(3) is with reference to a person who may carry more than one enterprise. In case of shipping business the application is with reference to the enterprise (*i.e.*, the shipping activity). Effective management refers to management of a ship or aircraft and the place may not necessarily be the headquarters of the owner.

Explanation under section 115VC of the Indian Income-tax Act, 1961, defines the place of effective management of a ship operating company to mean—

- A. the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or
- B. in a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place of such executive directors or officers of the company perform their functions.

If the effective management is aboard a ship or boat, it is, then, deemed to be situated in that State (1) in which is situated home harbour of the ship or boat, or, where there is no such home harbour, then the state (2) of which the operator of the ship or boat is a resident.

Only the Contracting State in which the effective management is situated has been given the right to tax—

- ♦•profits from the operation of ships or aircraft in international traffic (paragraph 1 of article 8);
- ♦•profits from the operation of boats engaged in inland waterways transport (paragraph 2);
- ♦•profits from the participation in a pool, a joint business or an international operating agency (paragraph 4).

Excepting "international traffic" other expressions such as "ships", "aircrafts", "boats", "inland waterways" have not been defined in the Model Convention.

Ships - Meaning

14.4-1 Ship means any large sea going vessel ; a large boat that carries passenger or cargo. The Illustrated Oxford Dictionary explains "...Today, ships are mainly turbine - or diesel powered, and include ocean-liners, some of which can accommodate 1,000 passengers...". Anything floating on the sea is not a ship. Arvid A. Skaar in the book Permanent Establishment, cited the Hotel Platform case, in which it was argued that the operation of an accommodation vessel was not to be subsumed under the international transportation clause. Emphasis was put partly on the stationary character of the platform, which is different from the mobile nature of international shipping, and partly on the construction of the vessel, which was not like a ship. The learned author observed, "The fact that the platform had its own engine was not sufficient to make it a 'ship' in terms of treaty, because the engine was only used to transport goods and personnel (except its own crew). A mutual agreement was reached at the end of 1988, concluding that the platforms were not engaged in international traffic."

Section 115VD of the Indian Income-tax Act, 1961 defines the expression for the purposes computation of profits from the business of operating qualifying ship under Chapter XII-G to mean, *inter alia*, a sea going ship or vessel, registered under the Merchant Shipping Act, 1958 but not including—

- i. a sea going ship if the main purpose of which it is used is the provision of goods or services of a kind normally provided on land;
- ii. fishing vessel;
- iii. factory ships ;
- iv. pleasure crafts ;
- v. harbour and river ferries;
- vi. offshore installations;
- vii. a qualifying ship which is used as a fishing vessel for a period of more than thirty days during a previous year.

Section 3(55) of the General Clauses Act, 1897, gives an inclusive definition of the word "ship" which is as follows :

"‘ship’ include every description of vessel used in navigation not necessary propelled by oars".

Ship, therefore, means all types of vessels which have one common factor or feature, that it is used in navigation. Any vessel used in navigation can be called a ship. Navigation means "communication by canals and rivers, voyage" (*see* The Concise Oxford Dictionary). To navigate means to sail over or up or down (sea, river) Chambers' Dictionary says that to navigate means 'to conduct or manage a ship in sailing or flying' and 'navigation' is 'travel or traffic by water or air'. So, conveying goods, men and material from one place to another is the *sine qua non* for being qualified as ship [*see Gammon India Ltd. v. CIT* [1997] [228 ITR 691](#) (Bom.)].

A ship for the purposes of article 8 must be the one which is engaged in the international transport of goods or persons. A ship which is not so engaged, but used for exploration or exploitation of offshore mineral resources is not covered, though it may carry its own crew and material, goods or equipment used by them. Offshore installations, fishing vessels, accommodation vessels, are, therefore, not ships under a treaty. The operation of drilling rigs is not international transportation (*see* US Drilling Rig, IRS in Letter Ruling 85-26-005).

Boat - Meaning

14.4-2 A boat is small vessel propelled on water by an engine, oars or sails (Illustrated Oxford Dictionary). A large boat is a ship.

Inland waterways transport - Meaning

14.4-3 The expression "inland waterways transport" has not been defined. Its meaning, however, could be gathered from paragraph 16 of the OECD Commentary on article 8, as not only transport on rivers, canals and lakes between two or more countries but also carried on by an enterprise of one country between two points in another country. It is distinguished from "international traffic" inasmuch as in the latter case, the State of place of effective management has the right to tax purely domestic as well as international traffic between third States, and to allow the other Contracting State to tax traffic solely within its borders (*see* OECD Commentary, article 3, paragraph 6). The Commentary explains by an illustration. "Suppose an enterprise of a Contracting State or an enterprise that has its place of effective management in a Contracting State, through an agent in the other Contracting State, sells ticket for a passage that is confined wholly within the first mentioned State or alternatively, within a third State. The Article does not permit the other State to tax the profits of either voyage. The other State is allowed to tax such an enterprise of the first-mentioned State only where the operations are confined solely to places in that other State." Thus, except for traffic solely within the borders of another State, the State of effective management has the right to tax income from transportation. The international traffic, as per the definition in article 3(1)(d), includes traffic between the Contracting States and also between any of them and a third State, but not between places within the same State. Under the term "State" is included not only its territory but also its territorial waters, and also continental shelf. (*See* the definition of "India", paragraph 9.16-2). Thus traffic between the mainland and the continental shelf or between the installations in the continental shelf is inland waterways traffic.

The rules with respect to the taxing rights applicable to both kinds of traffic are the same (OECD Commentary, article 8, paragraph 15).

Shipping business - Income derived from the operation of ships or aircraft - Meaning

14.5 The expression "international traffic" has been defined in clause (d) or paragraph 1 of Article 3, to mean any transport by a ship or aircraft by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State. The exclusion from international traffic of transport of solely between places with a Contracting State means, for example, that carriage of goods or passengers solely between say Bombay to Calcutta (both in India) would not be treated as international traffic, even if carried by an enterprise whose place of effective management is situated in a foreign country. A ship or aircraft is operated solely between places in other Contracting State in relation a particular voyage if the place of the departure and the place of arrival are both in the contracting State, even if part of the transport takes place outside that State. For example, a cruise beginning and ending in the same Contracting State without a stop in a foreign port does not constitute a transport of passengers in international traffic (*see* paragraph 6.3 of the OECD commentary on Article 3). In that case the State would not be required to exempt the income under Article 8. The income would be treated as business profits under Article 7 and would be taxable if attributable to permanent establishment. Such engagement cannot be said to be operation of ships or aircraft, *i.e.*, international traffic in terms of treaty provision.

However, if departure or arrival is at a place not situated in the other Contracting State, the voyage being international in the sense that it covers more than one country and the journey of the ship or aircraft between places in the other Contracting State forming part of the longer voyage, the definition still applies. Thus, where as a part of the same voyage, an aircraft first flies between a place in one Contracting State to a place in the other Contracting State and then continues to another destination also located in that other contracting State, the first and the second legs of that trip will both be a part of a voyage regarded as falling within the definition of "international traffic" (*see* paragraph 6.1 of the OECD Commentary on Article 3). For example, if the goods or passengers are carried by a non-resident carrier from a non-Indian port to say Bombay and some of the goods or passengers continue on to Calcutta, the entire transport would be international traffic.

Some recent agreements (*see* for example, agreement between India and Belgium which came into force in October, 1997) define income derived from the operation of ships or aircraft in international traffic by an enterprise, exhaustively and inclusively. The definition consists of two parts. It defines to mean and thus restricting and also to include and thus expanding. Not only the owner but also the lessee and charterer are covered.

It is defined to mean income derived from the transportation by sea or air respectively of passengers, mail, livestock or goods carried on by the owners or lessees or charterer of ships or aircraft, and to include income derived from :—

1. the sale of tickets for such transportation on behalf of other enterprises;
2. any other activity directly connected with such transportation;
3. leasing of ships or aircraft on charter fully equipped, manned and supplied, or on a bare boat charter basis where the leasing is incidental to any activity directly connected with such transportation;
4. the use, maintenance or rental of the containers (including trailers and the related equipment for the transport of containers) in connection with the transportation of goods or merchandise in international traffic, where the income is derived from an activity which is incidental to any activity directly connected with such transportation.

The above definition is indicative of what normally constitutes income from the shipping or air business. Not only transportation but also other incidental activities contribute to such income. (*See* also Indian agreement with Malaysia)

Shipping business profits - From the operation of ships or aircraft

14.6 The expression "profits from the operation of ships or aircraft" has been defined in paragraphs 2, 3 of the US Model Convention as to include—

- ◆ profits derived from the rental of ships or aircraft on a full (time or voyage) basis;
- ◆ profits from the rental of ships or aircraft on a bareboat basis if such ships or aircraft in international traffic;

- ◆ profits from inland transport of property or passengers if such transport is undertaken as a part of international traffic;
- ◆ profits from the use, maintenance or rental of containers (including trailers, barges, and related equipment for the transport of containers) used international traffic;

Paragraph 4 of the OECD Commentary explains the scope of profits as—

- ◆ profits directly obtained from by ships or aircraft whether owned, leased or otherwise at the disposal of the enterprise;
- ◆ profits from activities directly connected with large variety of activities which permit, facilitate or support international traffic operations of enterprises ;
- ◆ profits which are not directly connected with the operation of the enterprise's ships or aircraft so long as they are ancillary to such operation.

Activity directly connected with transportation means any activity carried on primarily in connection with the transportation (OECD Commentary, article 8, paragraph 4.1). Any other activity which is closely related to the operation is considered to be ancillary to such operation (*see* OECD Commentary, paragraph 4.2).

Certain non-transport activities that are an integral part of the services performed by a transport company are understood to be covered in paragraph 1. Income from shipping and aircraft is not restricted alone to income in relation to transport by a ship or aircraft operated by an enterprise, but also includes amounts which are referable to such activities. Operational activity, in order to become fully functional requires some supportive and auxiliary activities, such as transportation of goods by truck connecting a depot with a seaport or airport, containerization, the operation of bus service connecting town with its airport, the sale of passenger tickets, advertisements, delivery of goods to the consignee, maintenance of guest houses or rooms in hotels for the stay of passengers or crew during transit. Such are the auxiliary activities which have necessarily to be undertaken for the efficient operation of ship or aircraft. The cost of each of such activities is included in the ticket. The ticket is really the evidence of contract of carriage by ship or airline between the enterprise and the passenger. The purchase price of a ticket is quite different from the purchase price of physical goods or commodity. It is really a compensation paid for undertaking by the enterprise to transport the passenger or the cargo. All activities undertaken for the purpose of transportation or which support efficient carrying out the undertaking of transportation from one destination to another are part of the contract.

An establishment which is exclusively engaged in providing shipping transport facilities does not cease to be an establishment exclusively carrying on the said business merely because it sets up an on-shore workshop for effecting repairs exclusively to its own ships - *Cemindia Co. Ltd. v. Rachubhai N. Raval* AIR 1987 SC 1956. To carry on any activity which is essential for its business effectively, some other activity has been undertaken by an establishment. That establishment cannot be said that it has commenced to carry on another activity.

The OECD Commentary lists out some particular non- transport activities that may be integral part of the operation of ships or aircraft, are considered to be ancillary to such operation and profits from carrying on them covered under paragraphs 1 and 2 of the Article—

- ◆ leasing a ship or aircraft on charter fully equipped, crewed and supplied ; and also on bare boat charter basis if it is an ancillary activity of the enterprise (*see* OECD Commentary, paragraph 5) ;
- ◆ transporting otherwise than ships or aircraft if such transportation is directly connected with the operation of ships or aircraft in international traffic (paragraph 6);
- ◆ having some of its passengers or cargo transported by other enterprise under code-sharing or slot sharing arrangement or to take advantage of an earlier sailing (paragraph 6) ;
- ◆ operating bus service connecting a town with the airport in order to provide access to and from that airport to the passengers (paragraph 6);
- ◆ picking up passengers or cargo in the country where the transport originates or transporting or delivering in the country of destination by any mode of inland transportation operated by other enterprise (paragraph 7) ;
- ◆ selling tickets on behalf of other transport enterprises at a location maintained for the purposes of selling its own tickets (paragraph 8);

- ◆·advertising for other enterprises in magazines offered abroad ships or aircraft that it operates or at its business locations (paragraph 8.1);
- ◆·leasing, short-term storage, or late return of containers (paragraph 9);
- ◆·providing goods or services in a foreign country to other enterprises, by engineers, ground and equipment maintenance staff, cargo handlers, catering staff and customer services personnel (paragraph 10);
- ◆·providing spare parts or maintenance services to other airlines at a particular location under the pooling arrangements (paragraph 10.1);
- ◆·investing in stock, bonds, shares or loans if the investment is an integral part of the carrying on of the business of operating ships or aircraft (paragraph 14)
- ◆·operating vessels engaged in fishing, dredging or hauling activities on the high seas (paragraph 17.1).

Some of the above items have been covered in the exhaustive definition of the expression "profits from the operation of ships or aircraft" in the Indo-US treaty, which has been defined to mean to be the profits from the transportation by sea or air respectively of passengers, mail, livestock or goods carried on by the owners or charterers of ships or aircraft including, (a) the sale of tickets for such transportation ; (b) other activities directly connected with such transportation ; (c) the rental of ships or aircraft incidental to any activity directly connected with such transportation. It also includes—

- (a) profits from the use, maintenance or rental of containers (including trailers, barges, and related equipment for the transport of containers) used international traffic.
- (b) profits from participation in a pool, a joint business, or an international operating agency.
- (c) interest on funds connected with the operation of transportation.

Activities which are not auxiliary or incidental to the operation of international traffic are not covered; for example, operating shipbuilding yard (OECD Commentary, paragraph 12).

Some of the above propositions are discussed in the following paragraphs.

Shipping business profits - Includes interest on funds and Sundry investments

14.6-1 Interest on funds directly connected with the operation of ships, aircraft in international traffic is regarded as income from the operation of such aircraft and the provisions of article 8 will have effect and not those of article 11 (for example, *see* Indian agreement with Belgium). On such interest there would no withholding tax. Paragraph 14 of the OECD commentary on Article 8 states:

"...Thus, the paragraph would apply to interest income generated, for example, by the cash required in a Contracting State for the carrying on of that business or by bonds posted as security where this is required by law in order to carry on the business; in such cases, the investment is needed to allow the operation of the ships or aircraft at that location. The paragraph would not apply, however, to interest income derived in the course of handling of cash-flow or other treasury activities for permanent establishments of the enterprise to which the income is not attributable or for associated enterprises, regardless of whether these are located within or outside that Contracting State or for the head office (centralisation of treasury and investment activities), nor would it apply to interest income generated by the short-term investment of the profits generated by the local operation of the business where the funds invested are not required for that operation."

Shipping business profit - Investment income

Investments (stocks, bonds, shares or loans) if made as an integral part of the carrying on of the business of operating the ships or aircraft may be considered directly connected with such operation, and income arising therefrom as income of such a business. (*See* OECD Commentary, paragraph 14) The commentary explains by illustrations, interest income generated—

- ◆·by the cash required in a Contracting State for the carrying on of that business (not the income derived in the course of the handling cash-flow or other treasury activities for the permanent establishment/associated enterprises/head office, or generated by short-term investment of the profits), or
- ◆·by bonds posted as security where this is required by law in order to carry on the business.

In such cases, the investment is needed to allow the operation of ships or aircraft at that location.

Shipping business profits - Do not include profit from independent activity

14.6-2 Article 8 does not cover clearly separate activities such as keeping of a hotel as a separate business, the profits from such an establishment are in any case determinable, unless such keeping is for no purpose other than to provide transit passengers with night accommodation, in the nature of a waiting room. Similarly, shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country, is not covered (paragraph 12 of the Commentary). Sundry investments are also not covered (OECD commentary para 14). Whether the contract of transporting goods or passengers is a service contract or is an activity, is an important question for determining the place where income arises. In case of services, income arises where the service is rendered; and in case of activity, where the activity is undertaken. The question arose before the Supreme Court of Philippines. British Overseas Airways Corporation (BOAC) was required to pay tax on the income which could be said attributable to the sale of tickets in Philippines (*see* Asian Pacific Tax Investment News Service, Vol. 6, No. 4, April 1988 Issue). BOAC had no landing rights and the certificate of public convenience for the traffic purposes in the Philippines in the years 1959 to 1971. Hence, it did not carry passengers and/or cargo to or from Philippines though it maintained a general sales agent (GSA) in the Philippines for selling BOAC ticket for passengers and cargo. A question arose whether the revenue derived from the sale of its tickets in the Philippines by its GSA constituted Philippines' source of income. BOAC had urged that income, derived from transportation is income from services, has its source in the place where the service is rendered; that because the BOAC's service of transportation was performed outside the Philippines, the income therefrom was from sources outside the Philippines and was, therefore, not taxable under the Philippines tax laws. The Supreme Court in the majority decision, held that the test of taxability is the "source" and the "source" of income is the "activity" that produced income, *viz.* the sale of tickets in the Philippines. The activity of sale of tickets in the Philippines is clearly separate from the general activity of the BOAC of transporting of goods or passengers, as it did not carry its such general activity in the Philippines. Income arising from the sale of tickets in the Philippines could not be said to have been arisen from the activity of carrying of passengers and goods. If an activity is clearly separate, then it should be taxed as "permanent establishment". But if the activity has necessarily to be undertaken for the efficient operation of the shipping business or if it is auxiliary to it, then the income can be taxed as arising from that business.

Shipping business profits - Includes income from leasing

14.6-3 Leasing of containers are directly connected or ancillary to the operation of ships or aircraft. Profits from leasing is deemed to be derived from the business of such operation. The amount charged from a customer for keeping a loaded container in a warehouse pending delivery and for late return of the container is treated similarly (*see* OECD Commentary, article 8, paragraph 9).

Shipping business profits - Leasing whether incidental to activity directly connected with transportation

14.6-4 Profits from the operation of ships or aircraft may include profits derived from the rental of ships or aircraft on a full time or voyage basis, if such ships or aircraft are operated in international traffic by the lessee. On the other hand leasing on a bareboat basis is not covered by article 8 exception. Paragraph 5 of the OECD Commentary on article 8 observes "... However, Article 7, and not Article 8, applies to profits from leasing a ship or aircraft on a bareboat charter basis except when it is ancillary activity of an enterprise engaged in international operation of ships or aircraft." Bareboat charges according to the definition in section 115V of the Indian Income-tax Act, 1961, means hiring of a ship for a stipulated period on terms which give to the charterer possession and control of the ship, including the right to appoint the master and the crew. Thus, profits from the incidental lease of ships or aircraft used in transportation of passengers, goods or merchandise are deemed to be income from the operation of such ships or aircraft (*see* Indian agreement with Singapore). Freight collection is the basic requirement, which in the ordinary in mercantile sense is the reward payable to the carrier for the carriage of the goods. Where a line charter carries his own goods by hiring a ship, what he pays to the owner of the ship is not the freight but the hire charges - *Lima Leita & Co. Ltd. v. Union of India* [1968] [70 ITR 518](#) (Goa). The payment which the charterer agrees to make to the owners of the ship should be in consideration of the carriage of the goods, *i.e.*, the amount payable on account of the carriage of the goods. It has, therefore, to be shown that one is the consideration for the other. In *Union of India v. Gosalia Shipping (P.) Ltd.* [1978] [113 ITR 307](#) (SC), a non-resident

shipping company chartered a ship at an Indian port from another resident company. The ship was loaded with bauxite belonging to the charterers, and it left the Indian port for Canada. The charter party provided by a clause that the charterers shall pay a sum @ of 4.50 US dollars on the total dead weight carrying capacity of the ship, for the use and hire of the said vessel. Under the agreement charterers were at liberty to sublet the vessel for all or at any part of the time covered by the agreement. The captain of the ship was to be under the orders and directions of the charterers as regards employment and agency. And if the vessel lost money paid in advance and not earned was to be returned by the owners to the charterers. The question for consideration was whether the amount which the time-charterer had agreed to pay to the owner of the ship was payable on account of the carriage of the goods.

The Supreme Court held that under the terms of the agreement the owners of the ship received the amount as charges for the use and hire of the ship. The character of the payment could not change according to the use to which the charterers put the ship or according as to whether the ship was loaded with goods in a port in India. What was payable as hire charges for the use of the ship could transform itself into an amount payable on account of the carriage of goods, by reason of the circumstances that the ship was loaded with goods in India. The Supreme Court illustrated their judgment with a *similie* (though issuing a warning that *similie* can be misleading). If a hall is hired for a marriage, the charges payable to the owner are for the use and hire of the place, not on account of marriage.

Shipping business profits - Do not include profits derived from coastal traffic

14.6-5 Profits derived from the operation of ships in international traffic is subject to the treaty provisions; and not those derived from coastal traffic. Coastal traffic means traffic which originates and terminates in the territorial waters of the same Contracting State.

Shipping business profits - Operations more than casual

14.7 Under the OECD model profits from the operation of ships or aircraft in international traffic is taxable only in the contracting state in which the place of effective management of the enterprise is situated. Profits are taxable exclusively by the country of effective place of management (residence country). The exclusivity is qualified in article 8B of the UN model. They may be taxed in other Contracting State (*i.e.*, the Source State), if the shipping activities arising from the operation of ship in the other Contracting State are more than casual. The amount is determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation is then be reduced by a some percentage which is established through bilateral negotiations. Article 8B of the UN model, thus, contains an approach alternative to the method of exclusive taxation in the country of residence (effective source).

Shipping business - Activities more than Casual

14.8 The expression "casual" means subject to, resulting from or accruing by chance; occurring without regularity; occasional; employed for irregular period (Webster's dictionary). Shorter Oxford English Dictionary defines the word "casual" to mean (i) subject to or produced by chance; accidental/fortuitous; (ii) coming at uncertain times; not to be calculated on, unsettled. It means accidental or fortuitous, suggesting absence of any previously entertained object or intention - *Smt. Lalithamma v. R. Kannan* AIR 1966 Mys. 178 and *RM.AR.AR.RM.AR.AR. Ramanathan Chettiar v. CIT* [1967] [63 ITR 458](#) (SC). Shipping activities being more than casual may mean activities which are not casual or occurring without regularity, or even irregular or isolated shipping visits, provided they are planned for and not merely fortuitous in the circumstances. The phrase "more than casual" connotes a scheduled or planned visit of a ship to a particular country to pick up freight or passenger.

Shipping business profits - Determination and allocation to the source State

14.9 If the shipping activities are more than casual with reference to the State other than the State in which effective management is situated, the profits allocable to that State have to be determined on the basis of the agreed rules. What is available for allocation is the overall net profits derived by the enterprise from its shipping operations. "Overall net profits derived by the enterprise from its shipping operations" may be a contentious issue, which could be resolved by invoking the Mutual Agreement Procedure (article 25). How to proceed with determination of the allocable profits is a matter of mutual agreement. Some agreements provide the procedure. Protocol dated 25-10-1976 between the Malaysian and the Indian authorities which is an integral part of the DTA between the two countries, provides that the net profits as determined by the authorities of the country of residence

is the starting point. It furnishes a certificate which would be accepted by the other State. That certificate would show the gross income from wherever derived; income or loss in respect of shipping operations computed for the purpose of taxation in the residence state and the total depreciation allowances given (excluding any allowance brought forward from a previous period).

The other method is the determination of the profits on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operation. In some agreements, no basis is provided. What is provided is, "Profits derived from the operation of ships in international traffic may be taxed in the Contracting State in which such operation is carried on" (*see* Indian agreement with Sri Lanka or with France). There is, however, a rider. Tax should not exceed certain percentage (50% in case of Sri Lanka agreement) of the tax otherwise imposed by the internal law of that State. The rider may be applicable for a limited period. Agreement with France lays it 10 years; 50 per cent for the first five years after the entry into force of the agreement, and 25 per cent for next five. Thereafter, the entire profit would be taxable in the State of enterprise; other State would have no right. Some agreements provide how such profits are determined. The agreement with Kenya provides :

"(a) such profits shall be deemed to be an amount not exceeding 5 per cent of the full value of the amount received by the enterprise on account of the carriage of passengers or freight embarked in that other State;

(b) the tax chargeable in that State shall be reduced by an amount equal to 50 per cent thereof;"

Where the agreement does not deem the taxable profits, they are to be taken as provided in the domestic law. Section 44B of the Indian Income-tax Act, 1961, deems it to be seven and a half per cent of the amount payable or received or deemed to be received on account of carriage of passengers or freight. For the business of operation of aircraft, it is five per cent (section 44BBA).

Shipping business - India's approach to tax treaty

14.10 India tends to follow UN model and asserts its right as a Source State, with respect to international shipping profits. Some treaties recognise this. Formula for their allocation, however, is not uniform. It differs from treaty to treaty. In some, full operation of the exclusive right of the Residence State is suspended for the initial ten years in favour of the Source State with a rider that the tax charged according to the domestic law not to exceed 50 per cent for the first five years and 25 per cent for the next five (*e.g.*, *see* agreement with France). As regards international air traffic operations, the OECD model is generally followed. Profits derived is taxable only in Contracting State of the enterprise. Residence of the operator is the test, rather than the effective management (*see* agreement with France).

Shipping business - Treaty with Australia

14.10-1 The OECD model is generally followed. The right to tax has been given exclusively to the state of which the operator is the resident. Effective management is not the criterion. Source state right is recognised with respect to the profits derived from the operations of ships or aircraft confined solely to places in that State *i.e.*, carriage of passengers or goods or merchandise for discharge at another place in the State. Profits from the operation of ships or aircraft includes interest on funds connected with that operation.

Shipping business - Treaty with Canada

14.10-2 The treaty follows almost the same pattern as with the Australia discussed above. The expression "profits derived from the operation of ships or aircraft in international traffic" has been defined to mean and include profits in the manner as discussed in paragraph 8.5 above. The provisions of the article do not apply to a drilling rig or any vessel the principle function of which is the performance of activities other than the transportation of goods or passengers. Profits from such activities are taxable as business profits and the concept of permanent establishment becomes applicable.

Shipping business - Treaty with France

14.10-3 There are separate articles for air transport (article 8) and shipping (article 9). Profits derived by an enterprise of a Contracting State from the operation of the aircraft or ships international traffic is taxable only in that State. The term "operation of aircraft" has been defined to mean business of transportation by air passengers or goods by the owners or lessees or charterers of the aircraft, and also defined to include the sale of tickets for such transportation on behalf of other enterprises, the incidental lease of aircraft and any other activity directly connected with such transportation. As for the profits from the operation of the ships, these may be taxed by the

Source State provided the tax charged does not exceed 50 per cent (during the first five fiscal years after the entry into force of the agreement) and 25 per cent (during the next five) of the tax otherwise imposed by its domestic laws. Thereafter, the residence State will have the exclusive right. Interest on funds connected with the operation of the aircraft or ships is regarded as profits derived from such operation.

Shipping business - Treaty with Germany

14.10-4 The treaty follows the OECD model. Interest on funds connected with the operation of ships or aircraft in international traffic is regarded as profits derived from the operation of such ships or aircraft.

Shipping business - Treaty with Japan

14.10-5 Profits from the operation of the aircraft or the ships in international traffic carried on by an enterprise of a Contracting State is taxable only in that State. As for the profits from the operation of the ships, these may be taxed in the other State (source State) during a period of first ten taxable years or "previous years", provided tax charged does not exceed 50 per cent (during the first five years) and 25 per cent (during the next five) of the tax otherwise imposed by its taxation laws. Thereafter, the profits shall be taxable only in the residence State.

Shipping business - Treaty with Great Britain

14.10-6 Article 8 of the treaty with United Kingdom of Great Britain deals with air transport and article 9, with shipping. Profits derived from the operation of aircraft in international traffic is taxable in the state of the enterprise. On the same basis also is taxed income derived by an enterprise from the operation of ships and from the use, maintenance or rental of containers (including trailers and related equipment for the transport of the containers) used for the transport of goods or merchandise. The expression "operation of air craft" has been defined to include transportation of goods or passengers by the owners or lessees or charterers and also to include (1) the sale of tickets for such transportation on behalf of other enterprise, (2) the incidental lease of the aircraft on a charter basis, and, (3) any other activity directly connected with such transportation. The expression "operation of ships" has also been defined inclusively. It is to include income derived from the rental on a bareboat basis if such rental income is incidental to the income from the operation of ships. Gains derived from the alienation of aircraft owned and operated by the enterprise is to be taxed only in the state in which the income from the operation of the aircraft is taxable. Gains from the alienation of ships or containers is similarly taxed if either the income from their operation was taxed or they are situated outside the other Contracting State at the time of alienation. If they are not thus situated or not operated and income derived from such operation is not taxed, provisions of article 9 would not be applicable.

Shipping business - Treaty with USA

14.10-7 Profits derived by an enterprise from the operation of ships or aircraft is taxable in the State of the enterprise (and not of effective management). The expression "profits derived from the operation of ships or aircraft in international traffic" has been defined to mean profits derived from the transportation of passengers or goods by the owner, lessees, or charterers, and also to include from other activities relating to such transportation such as the sale of tickets, other directly connected activities, rental of ships or aircraft. Profits from the maintenance or rental of containers (including trailers, barges, and related equipment for the transport of the containers) are also included. Interest on funds connected with the operation of ships or aircraft is also taken to be the profits derived from such operation. Gains from the alienation of the aircraft or the ships or containers are similarly taxed.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - ASSOCIATED ENTERPRISES

ARTICLE 9

ASSOCIATED ENTERPRISES

1. Where :

- (a) *An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
- (b) *The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. *Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.*

3. *The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.*

IntroductionIntroduction

15.1 Article 9 provides how the transactions between the associates and affiliates of an enterprise are to be interpreted. These are looked upon as if between two independent enterprises to work out profits on the proposition that they represent the amount which should, but could not, have accrued by reason of imposition of conditions amongst themselves. It is an extension of the concept of the arm's length transaction as postulated by article 7. That article deals with transactions arranged because of the special relationship between the permanent establishment and headquarters. Article 9 deals with enterprises which are factually separate, but commonly managed or controlled or in some way associated. It enables the authorities to "rewrite the accounts of the enterprises if as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that State". Rewriting is authorised if, because of the subsistence of special relationship between the two enterprises, transactions have taken place not on normal open market commercial but on dictated terms. Profits are distorted and may be kept artificially low in some jurisdiction where taxation rates are high, and inflated in another where they are low through the mechanism of what is known as "transfer pricing". Article 9 is an attempt at prevention of shifting prices and consequently profits by transnational companies from a high tax to a low tax country. It consists of two paragraphs. Paragraph 1 enables the authorities to rewrite the accounts of the associated enterprises or the companies under the common control to ascertain true profits and tax them. It would mean double taxation of the same profits. Once in the country where they are artificially shifted and again in the country to which they actually belong. Paragraph 2 aims at preventing double taxation, by enabling the former to provide relief. The application of the article would result in the imposition of additional tax, which cannot be done unless the domestic law of the state empowers it. The treaty cannot impose any additional liability. The Indian Income-tax Act, empowers the State to do so. The Indian law on the subject is discussed in Chapter 53.

Associated enterprises - Ingredients of article 9(1)Associated enterprises - Ingredients of article 9(1)

15.2 The concept of arm's length principle as postulated in article 7 (OECD Model Convention) as between permanent establishment and headquarters, is contained in article 9 in relation to enterprises which are factually separate but in some way associated. Article 9 anticipates circumstances where, due to financial relationship between the enterprises in the two States may not take place on an arm's length basis. Arm's length transaction is an open market transaction *i.e.*, the transaction between the unrelated parties. The implication of that concept is that taxable profits in a jurisdiction may be adjusted to a level which reflects that which would have been the market price. The authoritative statement of the arm's length principle is found in paragraph (1) of article 9 of OECD Model Tax Convention, which provides:

"When conditions are made or imposed between associated enterprises in their commercial or financial relations which differ from those which would made between independent enterprises, then profits which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

What article 9(1) enables the authorities of a Contracting State is to include in the profits of an enterprise which could have accrued to it but for the conditions imposed between it and the other enterprise where the former participates, directly or indirectly in the management, control or capital in the other or where the same persons participate in such management, control or capital of both the enterprises. The conditions for the imposition of the charge are:—

1. Participation of an enterprise or the same persons in the management, control or capital of another enterprise ;
2. Imposition or creation of conditions between them in their commercial or financial relations for suppression of profits.

The extent to which the charge is created is the difference between the amount of profits which would have been made had there been no such conditions and the one which has been made because of them. There should be accrual of profits in the first instance and that such accrual suppressed to some extent because of the conditions imposed or created on account of the association in the manner as mentioned in 1 above. If the profits cannot be accrued at all and are not deemed to accrue, such association will have no relevance. The expression "profits" is associated with the words "which would but for these conditions, have accrued to one of the enterprises, but by reasons of these conditions, have not so accrued". To isolate "these conditions" and to satisfy the "but for" test, only the profits of the controlled transaction is taken into account.

Associated enterprises - Meaning

15.3 Associated enterprises for purposes of this article may mean an enterprise of a Contracting State or the same persons when participate directly or indirectly in the management, control or capital of an enterprise of the other State, so that conditions are made or imposed between the two enterprises in their commercial or financial relations different from those which would be made between independent enterprises.

Paragraph 1 of article 9 defines "associated enterprise". It consists of two parts ; part (a) defines it to be one when it participates directly or indirectly in the management, control or capital of the other enterprise and part (b) if the same persons so participate in both enterprises. The ingredients of the first part are: - first, an enterprise to be associated enterprise must be associated with another enterprise; secondly, the enterprise so associated must have interest in the business of another; and, thirdly, such interest is reflected by participation in the management or control or capital of each other, directly or indirectly. Mutuality of interest between the enterprises in the business of each other, whether direct or indirect, is necessary to label them associated enterprises. Each of them has direct or indirect interest. The quality and degree of interest may be different. The interest of one in the business of the other may be direct, while the interest of the latter in the business of the former indirect. That would not make any difference so long as each has got some interest, direct or indirect, in the business of the other as reflected by participation in the management, control or capital of the enterprise. The second part of the definition indicates that the enterprises are associated if they are managed or controlled by the same interest.

Associated enterprises - Management

15.3-1 Management means administration, control, etc. - *Ghanshyamdas Badrilal v. State of Madhya Pradesh* AIR 1969 MP 186. It may mean an executive authority, a term often employed as correlative of decision-making - *Eric L. Kohler, A Dictionary for Accountants, Prentice-Hall 1978 edn.*

Associated enterprises - Control

15.3-2 To control means to exercise power over the functioning and the policy of the enterprise. The power to regulate or to exercise directing influence over the activities of an enterprise means exercising the controlling power. The process by which the activities of an organisation are conformed to a desired plan of action would tantamount to exercising control. The expression 'control' means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person whether through the ownership of voting securities by contract or otherwise. In common parlance a person is said to have a 'controlling interest' in a company when such a person acquires, by purchase or otherwise, the majority of the vote-carrying shares in that company, for the control of the company resides in the voting powers of its shareholders. In this sense, the

directors of a company may well be regarded as having a 'controlling interest' in the company when they hold and entered in the share register as holders of the majority of the shares which, under the Articles of Association of the company, carry the right to vote. It is not, however, necessary that in order to have 'controlling interest', the person or persons who hold the majority of the vote-carrying shares must have beneficial interest in the shares held by them. These persons may hold the shares as trustees and may even be accountable to their beneficiaries and may be brought to book for exercising their votes in breach of a trust. Nevertheless, as between them and the shareholders and the company, they are the shareholders, and, such have a controlling interest in the company [see *CIT v. Jeewanlal Ltd.* [1953] [24 ITR 475](#) (SC)]. The relation whereby one or more corporations or other persons possess the power to choose at best a majority of the members of the Board of Directors of another corporation. The power is usually a direct one, evidence by the ownership of a majority of other's outstanding shares of voting capital stock, but an equally affective control may be of an indirect type : the possession of less than half of the voting stock (e.g., 26 per cent) may be sufficient to ensure the domination of the meetings of stockholders provided there exists, to the necessary degree, any one or more of the following conditions :

- Continued ability to obtain proxies from other stockholders
- Ownership of voting stock by subsidiaries, officers, employees' nominees or other persons having subordinated interests
- In activity of passive stockholders who do not attend stockholders' meetings and do not give proxies
- Possession of a lease or other contracts which carries with it the virtual ownership or exclusive use of assets without any formal ownership of capital stock

Occasionally instances are found where, although a majority ownership of capital stock exists, there is no domination of the other company's policies and hence no effective control, as where ownership is temporary or where a strong, self-sufficient management is in the saddle or where the other company is an obliger under a lease or contract of the type mentioned in the preceding sentence. It could, thus, be seen that the necessary element to identify the relationship between the two enterprises is the effective control. The Article 9 applies if an enterprise of one Contracting State participates directly or indirectly in the management, control or capital of the enterprise in the other contracting State. It also applies if any third person or persons so participate with regard to enterprises of different States. For this purpose all types of control are included, whether or not legally enforceable and however exercised or exercisable. The control should be effective, whether *de facto* or *de jure*.

Associated enterprises - 'Control and management' - Associated enterprises - 'Control and management' -

15.3-3 Control and management means the controlling and the directive powers, 'the head and the brain' as it is sometimes called - *CIT v. V.V.R.N.M. Subbiah Chettiar* [1947] [15 ITR 502](#) (Mad.). It means *de facto* control and management and not merely the right or power to control and manage - *CIT v. Nandlal Gandadal* [1960] 40 ITR 1 (SC). Thus, if an enterprise could participate in the management, control and the capital of another enterprise so as be able to influence direct its policy or management or functioning, or its transactions in such a manner as to secure the maximum tax benefits, the question of re-writing of their accounts will arise.

The illustration of such a relationship is found in dealings between a subsidiary and its principal. A subsidiary is a business enterprise which is controlled by another corporation. Its shares are owned by the controlling company (holding or parent company). A subsidiary differs from a branch of the parent company in that it has its own corporate entity and its own corporate character. The parent company forms a subsidiary either by purchasing the controlling share of an existing corporation or by setting up a new corporation and retaining the controlling share of its stock. When all the outstanding stock of the subsidiary is owned by the parent company, it is called a wholly owned subsidiary - *McGraw-Hill, Dictionary of Modern Economics, 1965 edn.* A foreign company or enterprise may be engaged in trade or business in the host country through a 'permanent establishment' which is more generally referred to as a 'branch office'.

The subsidiary or branch office or any other form of entity on which the foreign enterprise could exercise control and management in respect of its functioning, acts as an agency for preventing payment of taxes which would be due according to the intention of the tax authorities and tax legislators. The network of tax agreements shows discrepancies and loopholes which may induce many an international business enterprise to make use of the significant tax differentials between countries.

Associated enterprises - Computation of income ruleAssociated enterprises - Computation of income rule

15.4 The general rule for the computation of income of a branch office or a subsidiary is in principle the same as in for the computation of income of a domestic corporation. No distinction is made with regard to deductibility of expenses and allowability of allowances such as depreciation, or investment allowances, carry forward losses, deductible business expenses. Tax agreements affect the tax treatment of the subsidiaries and the branch offices. Some rules are deviated. These relate to (a) dealing at arm's length, (b) deductibility of expenses which are attributable to branch office, (c) non-deductibility of certain payments such as royalties and interests, (d) taxability of income which is attributed to branch office etc. Article 9 deals with (a) with respect to transactions between associated enterprises, while article 7, with respect to transactions between the branch office and the head office.

Associated enterprises - Arm's length transactions and shifting of profits

15.5 An arm's length transaction means a transaction as though between independent and unrelated persons, competitive and straight forward, involving no favouritism or irregularity without any consideration other than commercial. A buyer and a seller free to act, each seeking his own best economic interest and then agreeing on a price, are said to have an arm's length relationship. Transactions between the affiliated companies are not ordinarily recorded (or regarded by outsiders) as being arm's length even though expressed in terms of market value - see *Eric L. Kohler, A Dictionary for Accountants, Prentice - Hall, 1978 edn.* Article 9 anticipates circumstances where such companies may not indulge in transactions at arm's length, with a view to manipulating profits and shifting them to the desired destination. The implication is that profits may be kept artificially low in some jurisdictions by use of distorted "transfer prices". That article prevents happening such a situation by authorising the tax authorities to make adjustments so that the adjusted profits reflect the level which would have been achieved had open-market prices were allowed to operate. Such adjusted profit is known as arm's length profit. Transactions between the enterprises under the same common control may not be governed by open market considerations. Transfer prices *i.e.*, the prices paid for transactions may be fixed. When related parties enter into an arrangement, the specific arrangement must be examined to *see* whether or not it meets the arm's length standard. If it does not, adjustment may be made, which may include modifying the terms of the agreement or re-characterising the transaction to reflect its substance. The principal vehicles for their abuse are the following. To prevent it, the profit-element in these transactions should be taxed:—

1. Intra-group sale of goods;
2. Intra-group services;
3. Intra-group transfer of technology;
4. Intra-group loans;
5. Thin or hidden equity capitalization;
6. Treaty shopping (already discussed).

Tax may be avoided by way of transfer pricing. Transfer pricing is considered as a vehicle for the avoidance of tax. For that matter the concept is extended to income splitting, transaction splitting, inserting steps or transactions through the means of the associated companies, with no economic and commercial purposes.

For that purpose the Contracting States may apply internal law provisions relating to adjustments between related parties, and also to make adjustments in cases involving tax evasion and fraud. Such adjustments may relate to distribution, apportionment, or allocation of income, deductions, credits and allowances, even if they are different from or go beyond authorised by paragraph 1 of Article 9, as long as they accord with the general principles, *i.e.*, they reflect what the parties acting at arm's length would have done. Paragraph 4 of the OECD Commentary on Article 9 provides:

"The question as to whether special procedure rules which some countries have adopted for dealing with transactions between related parties are consistent with the Convention. For instance, it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes found in domestic laws are consistent with the arm's length principle. A number of the countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level. Also, almost all Member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may

result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with the situations by means of corresponding adjustments and under mutual agreement procedure."

Adjustments to profits and adjustments in cases involving tax evasion and fraud according to internal laws may be made, provided they accord with the arm's length principle. The matter about the application of the domestic law for such adjustments is discussed later.

Associated enterprises - Transfer pricing

15.6 Section 9 is of great importance with respect to transactions between group of enterprises controlled by multinational companies (MNC). MNC group of taxpayers are owned or controlled by the same interest. These are also termed as "transnational corporations" (TNC), which expression means enterprises with either substantive or formal economic activities in more than one jurisdiction. Such a corporation in its simplest form consists of a parent company resident in one country with controlled subsidiaries or subsidiaries in other. Transactions between enterprises under the same or common control are likely not to be governed by market considerations. Transfer of goods or commodities or merchandise or raw materials or stock or services is made at a price which is not dictated by the market but controlled by the consideration of shifting taxable profits or duties or other considerations of convenience. Reduction of profit artificially or causing losses or avoiding taxes or customs and excise duties in a specific country through manipulation is one of the aims and objects of the TNCs. Of late, the expression "transfer price" has acquired a pejorative meaning which conjures visions of furtiveness, manipulations and secrecy. Transnational enterprises are not the only entities that engage in transfer pricing abuses. There are many instances in which local individuals or companies use transfer pricing to shift artificially profits abroad so as to avoid or evade taxes, circumvent exchange control or reduce the economic exposure arising from political or economic uncertainties.

Associated enterprises - Transfer pricing motives

15.6-1 The strategy of 'transfer pricing' is assumed with the following main objects:

- To reduce profits artificially so that tax effect is reduced in a specific country
- To facilitate decentralisation of production so that efforts are directed to concentrate profits at the state of production where there is no or least competition
- To remit profits more than the ceilings imposed for repatriation
- To use it as an effective tool to exploit the fluctuation in foreign exchange to advantage.

Thus, the main object for resorting to the device of 'transfer pricing' is to appropriate maximum profits leaving very little for the revenue of the Government, or for the local participant. How best and dexterously it could be done depends on the tax structure of a jurisdiction, its exchange control regulations, its political and economic conditions, or its dependence on the foreign technology, know-how, skill, expertise. The incentives to engage in transfer pricing abuses are greater in less developed countries than those in industrialized countries with risk of detection being less.

Associated enterprises - Transfer pricing motive - Tax avoidance

15.6-2 Transfer pricing is perceived as a device to avoid tax in a jurisdiction where it is due. Intention for such avoidance is inferred where the transaction is highly structured, is artificial or is otherwise considered to be unnatural way of achieving an economic or business result. The affairs and transactions between the affiliates are arranged and rearranged and are carried out with the intent or object of tax avoidance. Such arrangements or rearrangements are devoid of *bona fides*. The right to transact business in a manner as to be the most beneficial is abused as to cause harm to the exchequer of the country from where profit is intended to be shifted. The countries are now to be alive to the harm caused to them by the related parties when they exercise their rights in relation to transactions *inter se* in a way which is beyond the normal exercise by a prudent man. They are, therefore, enacting laws to the effect that every person is bound to exercise his right and fulfil obligation according to the principle of good faith. The law does not sanction the evident abuse of a man's right. It is interpreted world over that contracts should be interpreted and performed according to the requirement of good faith. A currently accepted principle is that the exercise of the right is misused or abused in such a manner as to lead to the exercise of disproportion between the interests of the injuring party and those of the injured party (*viz.*, the State's exchequer), that the

former could not have reasonably decided to exercise his right in this way. The concept of abuse of rights imposes a reasonable limitation, whether codified or developed through judicial pronouncements on a person's liberty in order to prevent him from injuring others by exercising his rights in bad faith.

Avoidance of tax is the most important consideration of all others which motivate TNCs to adopt the technique of transfer pricing. Profit is intended to be shifted to a country where tax burden is less from a country where it is heavier, resulting in increase the after tax profits. This is because the tax differential being significant, either on account of its structure or of the incentives or rebates. Intra-firm transactions are manipulated by inflation or suppression of the price of goods, services by over invoicing or under invoicing of imports. Intra-firm transfer of amounts, therefore, are structured in a manner so that they are deductible by the payer in a high tax country and are taxed at a very low rate or not taxed at all in the country of the payee. Sometimes these amounts are given nomenclature which attract no tax, because taxes are not levied on such remittances.

Employment of transfer pricing technique with a view to avoidance of taxes is resorted to by the foreign based subsidiaries and the branches of the TNCs, when they are dealing with their parent and head office or with the other foreign subsidiaries or affiliates which are based in tax haven countries. A tax haven is a country that has no taxes, or has taxes at low rates, or where taxes are imposed on local income and not on foreign income, or where (though rates of taxes are normal), special concessions are offered to certain types of income or class of taxpayers (The OECD forum has observed recently that preferential tax regimes have spread rapidly in both OECD and non-OECD countries and so have tax havens).

Associated enterprises - Transfer pricing motive, tax avoidance and tax haven countries

15.6-3 International tax avoidance or evasion is resorted to by investment in or through tax havens. Division or shifting profits is manipulated, to a country which imposes little or no tax on income generated within its territory. Tax haven, is a country actively making itself available for avoidance of tax which would otherwise be paid in relatively high tax countries. This is because that country has no taxes, or has taxes at relatively low rates with respect to local income and not on foreign income. This includes "normal rate" countries which become unexpected tax havens, because they serve as tax shelters in some respect due to special tax concessions they offer to certain types of income or class of taxpayers. Though it goes without saying that investment in tax havens is tax motivated, there are other considerations too. Absence of exchange control on foreign deposits, tax agreements providing for exchange of information or provision of high level banking and commercial secrecy, are some of the few factors which influence foreign investment mainly of criminally obtained funds. Siphoning of profits to tax haven countries by shifting of fiscal residence, setting up base economic activities be it a holding or subsidiary company, using conduit companies in other countries to disguise income flows, using of technique of treaty shopping, are some of the means making investments in or through tax haven countries.

Associated enterprises - Transfer pricing motive - Exchange control and foreign investment

15.6-4 The under-developed countries lay heavy restrictions in regard to remittances of profits. But in their eagerness to secure access to foreign technologies, expertise, technical know-how, capital goods and components for their industrial development, they are liberal in regard to payment for these technologies etc. and make favourable and liberal exchange control regulations. Liberal regulations are made use of, and restrictions in regard to remittances of profits are circumvented, when a foreign company charges more than the market value as a consideration for imparting technology, services and other tangibles. For that matter the technique of transfer pricing is resorted to.

Many developing countries are very sensitive about foreign investment and, therefore, permit such investment on a restricted scale. The transnational corporations have changed their investment strategy in those countries. Instead of insisting participation on hundred per cent equity basis, they drain off the profits through excessive royalties, technical and management fees, overinvoicing of imported components and underinvoicing of exports. Such expenditure will result in reducing the profits to the extent of it being excessive. The profits are thus withdrawn before they are shared by the local participants, the revenue and finally the transnational corporation, through the transfer pricing techniques.

Associated enterprises - Transfer pricing, political and economic uncertainties

15.6-5 Unpredictability about political and economic stability of a country may necessitate flight of capital or profit therefrom. This flight is achieved through in device transfer pricing.

Associated enterprises - Transfer pricing - Indicia

15.6-6 Presence of various circumstances allude to shifting of profits or transfer pricing. Some of them are:

- Excessive commission, rebate or discount
- Maximising after tax income by disguising dividends as interest

Associated enterprises - Transfer pricing prevention - Domestic tax law

15.6-7 Sales of goods, transfer or licensing of technology patent rights, and provision of services are the vehicles for transfer pricing abuses. Intra-firm transfer relating to these vehicles requires to be looked into and cared for. Tax differential provides incentive for practising the mechanism of transfer pricing. So that this mechanism may not defraud a country where income arises or accrues of its legitimate due, the underdeveloped and developing countries have enacted laws which aim at taxing royalty, technical fee, dividend, interest, income attributable to services performed within those countries over relatively long period of time. Income arising from the sale of goods if such sale is attributable to 'permanent establishment' or to a 'business connection' in the host country is also taxable. Since income or at least a part of it arising on account of the sale of goods, or transfer of technology or services is subjected to tax in the host country, there remains nothing much to be done about shifting the profits from that country to another. On royalties, technical fee, interest payments, a fixed percentage of income is retained by the source country as withholding tax. The provision in the tax laws for taxing such income or for withholding tax thereon is not sufficient for preventing of the practice of transfer pricing, when the double taxation agreements provide for the rate of withholding tax at a substantially lower rate than the usual. Such low rate tax leave the income untaxed or taxed at low rate, may provide opportunities to multinational corporations to play upon the transactions with a view to shifting profits from one jurisdiction to another.

In case of service income many countries do not impose their tax unless the person performing services is physically present in the country for a substantially long period of time or the services are attributable to a 'fixed base'. With respect to sale of goods, since the countries limit their taxes to those sales attributable to 'permanent establishment', the transactions of sale are arranged outside the jurisdiction of those countries, and the goods are subsequently imported in them.

Non-deductibility of payments for goods, services while computing the profits of the payer of the connected parties will not result in tax saving through the device of transfer pricing. The net result would be that intra-firm payments are subject to tax in the host country at a regular corporate tax rates. In India, interest and royalty payments to affiliated enterprises are non-deductible unless the payer establishes that payments are consistent with normal commercial practice. The agreements with Indonesia, Belgium, Sri Lanka, Finland, etc., provide that no deduction shall be allowed in respect of amounts paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fee or other similar payments in return for use of patents or other rights or by way of commission, for specific services performed or for management or by way of interest on moneys lent to the permanent establishment.

Sometimes absolute prohibition of intra-firm transactions or restriction of expenditure in relation thereto may be an effective measure of preventing the abuse of transfer pricing. India has a very restrictive policy with respect to the payment of royalties to foreign enterprises. Such payments are generally restricted upto 5 per cent of the turnover for a period upto 5 years which may be extended to 8 years, or upto 1 per cent of the projected cost.

Associated enterprises - Transfer pricing prevention and recent trends OECD recommendation

15.6-8 Recently the Organisation for Economic Co-operation and Development (OECD) comprising of 30 member countries decided to take steps against the growth of the proliferation of harmful preferential tax regimes and tax havens. It observed that there is a harmful tax competition between the countries. Liberalisation and globalisation have led a number of governments to adopt harmful preferential tax regimes, particularly off shore regimes, not so much to attract real foreign direct investment, but as predatory policies whose main aim and purpose is to siphon off a part of another country's tax base. For example, from 1985 up to 1994, the value of investments into the low tax jurisdictions of Caribbean and south Pacific islands grew five fold to over \$ 200 billion. Even every OECD member country has adopted some type of preferential tax regime. It, therefore, made the following suggestions:—

- Countries which do not have any Controlled Foreign Corporation (CFC) rules should introduce and adopt them. For example, generally a US corporation is not subject to US tax on the profits of a non-US subsidiary unless they are repatriated as dividend. A CFC is non-US corporation in which more than 50 per cent of the share holding (either by vote or value) is owned by US shareholders. Now a US corporation is subject to tax on undistributed profits of this CFC. This is to counter tax evasion by setting up subsidiaries in low tax jurisdiction;
- Countries which do not have rules concerning reporting of international transactions and foreign operations of resident taxpayers should adopt these rules and exchange information with other countries;
- Transfer pricing rules should not be applied in a way that would result in harmful tax competition;
- Countries should also remove impediments to access of banking information by tax authorities;
- Countries must adopt fair and transparent rules for foreign investment funds;
- Countries where administrative decisions concerning the particular position of a taxpayer may be obtained in advance of planned transactions (India has a mechanism of advance ruling. An Authority for Advance Ruling has been established under the Indian Income-tax Act, 1961);
- Countries must make public the conditions for granting, denying and receiving of the aforesaid administrative decisions.

Associated enterprises - Transfer pricing impact on economy

15.6-9 The impact of 'transfer price' falls upon the economy of the underdeveloped, developing or poor country, in the sense that there is flight of capital from it to the MNCs without getting its legitimate due. Further, because of the monopolistic hold over the production and distribution of essential consumer items such as life saving drugs, the MNCs charge exorbitant consumer price, which not only causes great hardship to the consumers but also does immense harm to the exchequer of the country in the form of loss of tax revenue and foreign exchange. A small shift in internal price has comparatively a large effect on the profitability of the MNCs. The entire profit could be reduced to *nil* by lowering the price to the extent of the margin of profit, or be increased by increasing the price. Manipulation of profits becomes possible through the device of 'transfer pricing'. It refers to the value attached to transfer of goods, services and technology between related parties, such as parent and subsidiary corporations or sister corporations, or between unrelated parties which are controlled by a common entity.

To ascertain whether a particular transaction is at arm's length, or aims at shifting or distorting income, is very difficult. This is because the taxing authority of the host country has no access to the books of account or documents of non-residents to verify the truthfulness of the transaction or the extent of suppression of profits. Some assumptions have, therefore, to be made in this regard about the loss to the profits if the transaction appears to have effected in deflation of profits.

Associated enterprises - Transfer pricing and transfer of technology

15.6-10 Transfer of technology or the right to use the technical know-how is often made conditional upon the transfer of plant, equipment, input or their spare parts, or of services of parent company's personnel. Such transfer of goods or services may not be necessary for the use of technology; yet it is affected as a 'transfer price' technique, as a measure usually adopted by the parent company to appropriate more amount as consideration for its wares which the local laws could have legally permitted for remittance. Royalties are also sometimes paid to affiliates which are not entitled to them in absence of any of their contribution to the development of technology or creation of any right in it through some mutually agreed upon contract.

Associated enterprises - Transfer pricing and loans

15.6-11 Formation of group finance companies is notified by tax savings. Its formation in a tax haven country may result in the accumulation of profit because of its non-taxability or taxability at a very low rate. Or, otherwise saving is effected through the arrangement of loan from a bank, a so-called back-to-back loan, or through the formation of another subsidiary in a jurisdiction which affords treaty protection.

A back-to-back loan calls for deposit in the bank of an amount corresponding to the amount loaned to the other party. Loan is given in one country, whereas deposit is made in another. The difference of interest paid and received by the bank is called 'spread'. The deposit is preferably made in a tax haven country. Interest received

from the bank suffers little tax, while at the same time interest paid on the loan granted is allowed deduction resulting in the reduction of the taxable profit and subsequently accumulation of profits thus saved. The 'conduit' loan involves a preordained arrangement of being advanced to a subsidiary company incorporated in a country with a treaty network which provides the elimination of tax on interest thus earned or for taxing it at a lower rate than the usual. The Netherlands is the favoured country, as the receipt of interest is protected by its treaty network while at the same time Dutch domestic tax laws do not provide for withholding taxes. But difficulty arises when the activity of advancing loan is deemed to be the business of the company because of it being systematically followed or when one of the purposes for the formation of company is to advance loan. The taxing authorities will then insist upon an element of profit remaining within the country, by taxing it as arising accordingly in that country either wholly or so much as is attributable to the activity in that country.

Associated enterprises - Transfer pricing and formation of subsidiary

15.6-12 For diversion of profits, the formation of a subsidiary company is another device. Such an instance is found from the facts of a case - *CIT v. Assam Consolidated Tea Estates Ltd.* [1987] [167 ITR 215](#) (Cal.). The assessee was a non-resident company incorporated in UK and had been carrying on business in India by running tea estates. Another subsidiary company to the assessee was incorporated in UK pursuant to the agreement entered into between the said subsidiary and the assessee. The assessee transferred and conveyed to the subsidiary the business in India and the subsidiary company issued to the assessee certain shares and redeemable unsecured loan stock under an instrument as consideration for the said sale. The question was whether the aforesaid interest payable on the unsecured redeemable loan stock was assessable under section 9(1)(i) of the Indian Income tax Act, 1961.

The Calcutta High Court held that the assessee was not carrying on any business in India whatsoever. Though previously the assessee owned and ran the business but the same was transferred to the subsidiary and in the relevant assessment year the same were owned and ran by the subsidiary and not by the assessee which was an entity separate and distinct. Even otherwise, there was no continuity of any business of the assessee in the hands of the subsidiary had been established. The interest under the loan stock was, therefore, held as not accruing or arising in India from any business connection in India.

Associated enterprises - Transfer pricing and thin or hidden capitalisation

15.6-13 Article 9 permits tax authorities to deal with thin capitalisation issues. They may scrutinise more than the rate of interest charged on loan between related parties and also examine the capital structure of an enterprise, whether a payment in respect of that loan should be treated as interest and if so treated the circumstances under which interest deductions allowed to the payer. According to paragraph 3 of the OECD Commentary on Article 9 -

- (a) the Article does not prevent the application of the national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;
- (b) the Article is relevant not only in determining whether the rate of interest provided for in a loan is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;
- (c) the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.

Sometimes, equity investment is disguised as loan and interest charged as 'agreed upon' far exceeds the normal rate on trading credit. A local management company may be granted loan by its parent in the form of machine, plant or equipment which in turn are re-loaned to a sister company under the same management and control for a consideration. The amount of consideration received as interest passes off to the parent foreign company through the means of the locally managed company. This arrangement poses a problem which is difficult to be resolved, to trace whether the loan is an equity investment and the amount received by the parent company represents dividend; or whether the machineries, plant or equipment in fact and in actuality represents loan. The difficulty arises because the contract of loan is a managed affair between the related companies. If a subsidiary in one country is founded by a parent in another, the group will pay less tax in total if the former transfers its profits to the latter in

the form of interest which is deductible from taxable profits rather than as non-deductible dividend. A close scrutiny has, however, to be made about the companies that seem to have excessive debt/equity ratio to find out whether part of their loan finance is tantamount to equity finance, such as where an establishment which has a special relationship with the company provides a larger amount of loan capital than an independent enterprise would have done. In the case of the arm's length principle (*i.e.*, the price or amount which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market) part of the interest payment could be taxed as though they were dividends.

The tendency to provide finance to the company in the form of loan rather than equity is motivated mainly by tax consideration. Tax advantages of loan capital may induce the parties to provide equity capital in the form of loan. This phenomenon is known as 'thin capitalisation' or 'hidden capitalisation'. Since the tax advantage is secured at the cost of the exchequer, the Governments have enacted laws to prevent loss to it through the device of 'hidden capitalisation', especially when the 'lender' is a related person. A high debt/equity ratio may indicate, though not necessarily always, an attempt to gain tax advantage. The intention to pander to itself advantage through this arrangement becomes more pronounced in multinational groups. The group will pay less taxes, if the subsidiary which is founded in a country other than the country of the residence of the parent, transfers profit to the parent company in the form of interest which is deductible as a business expenditure before the profit is subjected to tax rather than a non-deductible dividend. To masquerade dividend as interest or equity capital as loan, the intention becomes apparent if the debt/equity ratio of an assessee is very heavy in case an organisation which has a special relationship (for example ownership) with the company which provides a larger amount of loan capital than an independent institution would have done. In that case a part of the amount represents dividend but is paid as interest. Such amount could be taxed as though dividend, on the arm's length principle namely, by holding so much amount as loan as would have been agreed upon between unrelated parties engaged in the same or similar conditions in the open market.

As about the rate of interest, the same principle of arm's length transaction becomes applicable, as the amount of consideration which would have been agreed upon in the open market between the unrelated parties under the same or similar circumstances, as representing interest. Arrangement of capital for the functioning of a subsidiary company is planned with a view to saving taxes as far as possible, in the form of loan rather than equity, because as aforesaid interest on loan is deductible before taxable profit is determined and is, therefore, saved from having to suffer tax to the extent which the profit does. Thus, instead of providing finances for the company in the form of equity, it is done in the form of loan so that the capital of the company is very small or thin. This exercise, however, becomes futile when the tax system of the country provides a high rate of withholding tax (as a counter to tax planning aimed at undermining its revenue), so that it equals the value of tax deduction. The exercise, however, is not left at that. It is then undertaken through the formation of group finance companies.

Associated enterprises - Transfer pricing and evasion of tax

Income splitting

15.7-1 The multinational companies (MNCs) operate in a number of countries. So that the combined tax effect on their income should be minimal, they resort to devices known as tax fragmentation or income splitting. Tax fragmentation involves spreading of income as if arising in number of countries, so that each constituent is subjected to differing tax treatment, the sum total of which is considerably less than what would have been the tax consequence had the transaction been taken as composite one whole in one country. Similarly, income-splitting consists of dividing one composite contract into a number of separate contracts which may be spread over a number of countries in such a manner that the bulk of the profits arise in low-tax a rate country. This is usually practised in a contracting business. The profit is assessable in the country where such contract is undertaken whilst the sale of equipment supplied as a part of the contract arises in another country. A contract for work may involve sale of goods if there is an independent term in the said contract for the sale of any specific goods. This is possible where not only work is to be done but the execution of work requires material to be used. Thus, the execution of work is performed in one country and the sale of goods required for such execution, in the other. The contract agreed upon is thus divisible. The composite contract by arrangement is split up into many constituents mainly two, one for the sale of goods and the other for work and labour. The term income-splitting is adopted to distinguish the practice from transfer pricing.

Associated enterprises - Transfer pricing and evasion of tax - Splitting of a contract

Transfer pricing and evasion of tax - Splitting of a contract

15.7-1A Where not only work is to be done but the execution of such work requires material to be used, may take one of the three forms:

- The contract may be for the work to be done for remuneration and for supply of materials used in the execution of the work of a price
- It may be a contract for work in which the use of materials is accessory or incidental to the execution of work
- It may be a contract for supply of goods where some work is required to be done as incidental to sale.

Where the contract is of the first type, it is a composite contract consisting essentially of two contracts, one for the sale of goods and the other for work and labour. The second type of contract is clearly a contract of work and labour not involving the sale of goods. The third type is a contract for sale where goods are sold as chattels and some work is undoubtedly done, only an incidental to sale. No difficulty arises where the contract is of the first type because it is divisible and contract for sale can be separated from the contract for work and labour and the amount payable under the composite contract can be apportioned between the two. The real difficulty arises where the contract is of the second and the third type, because in such a case it is always a difficult and intriguing problem to decide in which category the contract falls. The dividing line between the two types of contract, is somewhat hazy and 'thin partitions do their bounds divide'. But even so the distinction is there and it is very much real and an ingenious exercise has to be performed for distinguishing one from another - *Sentinel Rolling Shutters & Engg. Co. (P.) Ltd. v. CST* AIR 1978 SC 1747.

A contract for works can be said to involve sale of goods if there is an independent term in the said contract for the sale of any specific goods by one party to the other for money consideration and not merely an incidental transfer of title to some goods as ancillary to the performance of work or service.

A question often arises whether a contract is a work contract or a contract for sale, if in undertaking the contract the contractor uses some material. The primary test is whether the contract is one the main object of which is transfer of property in a chattel as a chattel to the buyer, though some work may be required to be done under the contract as ancillary or incidental to sale, or it is carrying out of work by bestowal of labour and service and materials are used in execution of such work. The primary difference between a contract for work or service and a contract for sale of goods is that in the former no property in the thing produced as a whole vests in the person performing work or rendering service. In the case of a contract for sale, the thing produced as a whole has individual existence as the sole property of the party who produced it sometime before delivery and the property therein passes only under the contract relating thereto to the other party for price - *Ram Singh & Sons Engg. Works v. CST* AIR 1979 SC 545, *CST v. Purshottam Premji* [1970] 26 ITR 38 (SC) and *State of Himachal Pradesh v. Associated Hotels of India Ltd.* AIR 1972 SC 1131.

It is, therefore, necessary in every case to find out whether in essence there is any agreement to work for a stipulated consideration. If that were so, it would not be a sale because even if some sale may be extracted that would not affect the true position. The nature and type of the transactions are important and determinative factors. What is necessary to find out is the dominant object. Mere passing of property in an article or commodity during the course of performance of the transaction in question does not render the transaction to be transaction of sale. Even in a contract purely of work or service, it is possible that articles may have to be used by the person executing the work and property in such articles or materials may pass to the other party. That would not necessarily convert the contract into one of sale of those materials. In every case, it has to be found out what is the primary object of the transaction and the intention of the party while entering into it. In order to constitute a sale, it is necessary that there should be an agreement between the parties for the purpose of transferring title to goods which, of course, presupposes the capacity to contract and that it must be supported by money consideration, and that as a result of the transaction, the property must actually pass in the goods. Unless all these elements are present, there would be no sale - *Hindustan Aeronautics Ltd. v. State of Karnataka* AIR 1984 SC 744 and *State of Himachal Pradesh v. Associated Hotels of India Ltd.* AIR 1972 SC 1131. Thus, in a contract for repairing a coat the parties cannot be regarded as having entered into a contract for the sale of thread which was stitched into the coat and which thereby became part of coat in the process of carrying out repairs.

Associated enterprises - Transfer pricing and evasion of tax - Splitting of engineering contracts

Associated enterprises - Transfer pricing and evasion of tax - Splitting of engineering contracts

15.7-2 By splitting the several operations carried on by an establishment in connection with his main business, the person cannot be said to have established separate units or establishment. If any establishment carrying on the business of engineers and engineering contractors which is exclusively engaged in building and construction industry, such activity forms part of the building and construction activity.

In order to discharge effectively its functions as engineers and engineering contractors engaged in building and construction industry, an establishment has to maintain a workshop or workshops where the works of smithy, welding, cutting, carpentry, etc., are carried on. Without these operations it is not possible for any person to carry on satisfactorily the work of building and construction industry. The reason for taking this view is obvious. An establishment exclusively engaged in running a hospital does not cease to be an establishment exclusively carrying on the said business merely because it sets up a pharmacy section for preparing and compounding medicines to be used exclusively by the patients at its hospital. Similarly, an establishment which is exclusively engaged in providing shipping transport facilities does not cease to be an establishment exclusively carrying on the said business merely because it sets up an on-shore workshop for effecting repairs exclusively to its own ships. Such illustrations may be multiplied. The point which is made out by these illustrations is that where an establishment is engaged exclusively in carrying on a particular type of business by setting up any place of work with a view to carrying on the work of repairs, etc., to the tools, equipment, vehicles, etc., used in its business or to carry on any other activity which is essential for its business effectively and which is not used to carry on the work for the benefit of any third party but utilised exclusively for the business of the establishment, such establishment does not cease to carry on exclusively the business in which it is engaged. It cannot also be said that the establishment has commenced to carry on another industry by setting up of such a place of work - *Cemindia Co. Ltd. v. Rachubhai N. Raval* AIR 1987 SC 1956.

Associated enterprises - Transfer pricing and evasion of tax - Splitting of transactions without economic contents not permissible

15.7-3 The transactions may be split into a series of such transactions so that each may be looked upon as an independent source of income; though in substance the entire series is nothing but in substance constitutes one composite transaction. By fragmenting the transaction income is also fragmented so as to appear arising in different jurisdictions. Till recently such arrangement could have been permissible, as a person is master of his own affairs who could arrange them in a manner most suitable and beneficial to him.

The doctrine that every man is entitled if he can to order his affairs so as that the tax attracted under the appropriate Act is less than it otherwise would be, as propounded by Lord Tomlin in *IRC v. Duke of Westminster* [1936] AC 1 and as followed in India in *CIT v. A. Raman & Co.* [1968] [67 ITR 11](#) (SC), *CIT v. B.M. Kharwar* [1969] [72 ITR 603](#) (SC) and some other cases, has long back been given a befitting burial in the *W.T. Ramsay Ltd. v. IRC* [1981] All ER 865, *IRC v. Burmah Oil Co. Ltd.* [1982] STC 30 and *McDowell & Co. Ltd. v. CTO* [1985] [154 ITR 148](#) (SC). In India Justice Desai of Gujarat High Court recorded a sign of departure from the principle in *Wood Polymer Ltd. In re* [1977] [109 ITR 177](#) (Guj.) and *Bengal Hotels (P.) Ltd., In re* [1977] 47 Comp. Cas. 597 by refusing to accord sanction to the amalgamation of companies as that would lead to avoidance of tax. The departure was completed by the Supreme Court in the case of *McDowell & Co. Ltd. (supra)*. Lord Brightman in *Furniss v. Dawson* [1984] AC 474 (HL) stated that the formulation of Lord Diplock in *Burmah Oil Co. Ltd. (supra)* expresses the limitations of the Ramsay principle. First, there must be preordained series of transactions; or, if one likes one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (*i.e.*, business) end. Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax 'no business effect'. If these two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.

A series of transactions if preordained is a single composite transactions - For rejecting a device aimed at saving the tax the formulation of the law veers round two concepts. First, there should be preordained series of transactions, *i.e.*, one single composite transaction, and the other, there must be steps inserted which have no commercial purpose apart from the avoidance of tax liability. A question arises what does the expression 'preordained series of transactions' mean : whether it means the transaction intended to have effect as part of a nexus or series of transactions or as an ingredient of a wider transaction intended as a whole.

The revenue authorities might heavily rely upon the decision of the Supreme Court in *McDowell & Co. Ltd.*'s case (*supra*) and of the House of Lords in *Furniss* case (*supra*) in rejecting an assessee's all attempts at saving the tax if he is entitled to do so legitimately, on the basis that the transactions were preordained or were inserted with a view to avoiding tax, without making a serious attempt to understand the implication of the expression 'preordained series of transactions'. While interpreting this expression they may tempt to take it as if they are words of an Act. Recently this expression has been subject-matter of discussion in the three English cases, viz. *Baylis v. Gregory* [1987] STC 297 (CA), *IRC v. Bowater Property Developments Ltd.* [1987] STC 297 (CA) and *Craven v. White* [1987] STC 297 (CA). Salde LJ summarised the reasoning in striking contrast to the decision in *Dawson* as follows :

"I conclude that two successive transactions, each of which has legal effects are not properly to be regarded as a preordained series or as a single composite transaction within the meaning of the first Ramsay condition as stated by the House of Lords unless, at the time when the first transaction was effected, all essential features (not merely the general nature) of the second transaction had already been determined by a person or persons who had the firm intention and for practical purposes the ability, to procure the implementation of the second transaction."

Thus, the expression 'preordained series of transactions' contemplates that the person has in contemplation the sequence of transactions when he takes the first step, to follow that step with the intention of saving tax. If there is no planning without the next step being arranged or the next step was expected but did not in fact materialise or the next step was one and probable more likely, of the two possible outcomes, that subsequent steps cannot be said to be preordained series of transactions. If there is an intention to carry out the next step, that intention of the taxpayer alone should not be the test of whether there was preordained series of transactions. What is required to be proved is that at the time of the first transaction it was intended by the taxpayer that the first transaction is used as conveyancing machinery in order to achieve the final object of saving the tax. One cannot have a composite transaction unless the second part has been pre-arranged or preordained at the time of the first. In *Ramsay & Dawson* the reasoning had been that there is no difference between series of steps which are followed though as part of an arrangement which falls short of a contract and a series which are carried out under the contract. By the same reasoning a quasi-contract in the absence of one of the parties being identified cannot be said to be an arrangement through a contract. If there is an uncertainty and difficulty in practice about the next step, it is very difficulty to tax the income at the first stage on the basis that second stage is bound to happen. The Court of Appeal in the aforesaid decisions, therefore, pointed out that preordained series of transactions or a single composite transaction cannot be taken to be the one where the next step has not been arranged or has not in fact materialised or the next step is one and probably the more likely of the two possible outcomes.

The Supreme Court in *LIC v. Escorts Ltd.* AIR 1986 SC 1370 observed that merely the form cannot control the Acts, the Rules or the directions.

Only under the following circumstances tax avoidance can be inferred :

- There is no economic or other significant reason which could justify the transaction
- The existence of the intent to avoid tax can be clearly established
- Acts leading to its occurrence are unusual or artificial and give rise to the situation where the letter of the tax regulation does not apply but differs so little from a situation provided for under the regulations that the purpose and the spirit of the regulations would be frustrated if it were to be declared inapplicable.

The proposition cannot be accepted in its entirety that a transaction may be disregarded for tax purposes solely on the basis that it was entered into without any *bona fide* business purposes. A strict business purpose test in certain circumstances would run counter to the apparent legislative intent which in the modern taxing statutes may have a dual aspect. Income-tax legislation is no longer a device to raise revenue to meet the cost of governing community. It is also employed to attain economic policy objectives. The statute is mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to a taxpayer to undertake by or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no *bona fide* business purpose. Thus, by imposing a positive requirement that there be such a *bona fide* business purpose, the taxpayer might be barred from undertaking the very activity Legislature wishes to encourage. At minimum, a business purpose requirement might inhibit the taxpayer from undertaking a specified activity which the Parliament has invited in order to attain economic and perhaps social policy goals. Indeed, where the Parliament is successful and taxpayer is induced to

act in a certain manner by virtue of incentives prescribed by the legislation, it is at least arguable that the taxpayer was attracted to this incentive for the business purpose of reducing his cash outlay for taxes to conserve his resources for other business activities. The tax authorities may presume that tax avoidance was intended if the taxpayer chooses to carry out transaction which may be regarded as unusual.

Avoidance occurs when the taxpayer takes advantage of a provision of law, the formulation of which is obscure or incomplete or very complex, so that he can reduce or avoid his liability while remaining within the limits of the law. If, however, the taxpayer is acting against the will of the Legislature even if he remains within the literal interpretation of law he can be said avoiding the tax. The revenue authorities cannot brush aside any and every attempt of an assessee at saving the tax if that attempt is sanctioned by the law or hold the assessee guilty of avoidance when the saving is the result of series of steps which at the time of taking the first step could not be in contemplation of or devised by the assessee.

Associated enterprises - Arm's length price - Methods for determination Associated enterprises - Arm's length price - Methods for determination

15.8 Article 9(1) though allows the tax authority to make an adjustment to the profits as reported in order to bring them for the purposes of taxation to what is briefly described as arm's length profit, there is nothing in that article how a tax administration would go about ascertaining arm's length price in order to arrive at arm's length profit. The US published regulations in 1968, setting out in some detail various methods by which taxpayers could calculate themselves the arm's length prices to be used, for tax purposes, for intra-firms transactions. In 1973, the OECD's Committee on Fiscal Affairs set up a Working Committee to look into the possibility of producing internationally acceptable guidelines for ascertaining arm's length prices in order to arrive at arm's length profits. The Working Committee produced a series of reports focussing on various kinds of intra-group transactions (Sale of goods, services, transfer of technology and loans etc).

These reports were put together and published in 1979 under the title "Transfer Pricing and Multinational Enterprises". It affirmed the arm's length approach as outlined in article 9(1). The suggested methods are:—

1. The comparable uncontrolled price method;
2. The resale or resale *minus* method;
3. The cost-*plus* method;
4. The fourth method (if none of the above is appropriate).

The Committee on Fiscal Affairs in its report of 1995 generally reaffirmed the conclusions of the 1979 report, while:—

- upholding of the arm's length principle;
- recommending the use of the three standard methods of arriving at arm's length prices;
- discouraging the use of comparable profits and profit split approach, except as methods of last resort or as instrument of selecting cases for examination;
- recommending firmly against global or unitary approach;
- recommending against the requirement of strict orders of priority for the use of various methods;
- advising against the use of safe haven or safe harbour ranges of prices;
- advising against conclusions based on hind sight and the making merely minor or marginal adjustments;

On administrative matters,

- advising examination practice (including simultaneous auditing or examination of the accounts of associated enterprises by more than one tax authority);
- advising for advance pricing agreements;
- advising about the amount and kind of documentation which can be reasonably demanded from the enterprise whose transfer pricing is subject to scrutiny by tax authorities.

The other recommendations in the 1995 report related to matters which were not either considered or were simply touched upon in the earlier, regarding transfer pricing. For example, the need to indicate a range within which the arm's length price may be regarded as falling; the incidence of the burden of proof in transfer pricing cases; the need for flexibility and rationality in the operation of national rules of burden of proof; the helpfulness of the data

relating to more than one year; the function of penalties as not being disproportionate to the offence; the corresponding and compensatory adjustments. The report also made valuable suggestions with regard to trade of intangibles and services (discussed later).

The guidelines how the arm's length principles should be applied in 1979, were revised by the Fiscal Affairs Committee in 1995. In particular, much new material was added on comparability and transfer pricing methods, including profit methods. Comparability means how to tell if a transfer is between the independent parties is really similar to a transfer within a group. In April, 1996 new chapters were published looking at intangibles and services. In August 1997, a new chapter on cost contribution arrangement (CCA) was issued. In February 1998, Annexes were published containing practical examples and procedures for monitoring the implementation of the guidelines. The Committee on Fiscal Affairs developed Taxation Framework Conditions setting forth the governing principles relating taxation issues and transfer pricing. These were approved by Ministers at the Ministerial level Conference held in Ottawa in October, 1998. These relate to electronic commerce activities. The matter is discussed later.

The OECD Guidelines set out methods which may be followed for calculating arm's length price. The Indian Government did it in 2001 through an amendment in the Indian Income-tax Act, 1961. What links the arm's length principle as propounded under Article 9 of the OECD Model Convention and arm's length transfer pricing methodology as provided under section 92C of the Indian Income-tax Act, 1961, is the concept of comparability ; comparability of the product, comparability of the conditions, and comparability of the entities. Two transactions are comparable if the price or the free market margin is not affected by any of the differences between them or between the characteristic of the enterprises, or if affected the effects of such differences is offset by making adjustments. Comparability, therefore, involves comparison of conditions of taxpayer's relations with those of independents and determination of quantum of adjustments. It is the comparison of the taxpayer's profits with the profits which would have accrued at arm's length, which could be gathered from the following statement in paragraph 1 of the article :

The authoritative statement of the arm's length principle is found in paragraph (1) of the article :

"When conditions are made or imposed between associated enterprises in their commercial or financial relations which differ from those which would made between independent enterprises, then profits which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Commercial and financial relations

Article 9 is applicable in case where commercial and financial relations between the associated enterprises are differently conditioned or structured from those between the unrelated parties. These are controlled and not governed by open market considerations. Commercial relations may refer to controlled transactions and financial relations to thin capitalization). Such relations include—

- controlled transactions at an agreed price and/or under certain terms and conditions, and
- arrangements providing benefits to other group members for no consideration.

Commercial or financial relations - Transactions

Commercial or financial relations between the associated enterprise may manifest in the form of a transaction between them A transaction has two elements—

- price, and
- terms and conditions.

Both should be at arm's length, before a transaction can be so said. To so establish, a comparison has to be made with the uncontrolled similar transaction between unrelated parties. What those parties would have charged under the same terms and conditions, is the arm's length price of the controlled transaction. If the price charged is the same, but terms and conditions differ, or the price differs but the terms and conditions are the same, the transaction is not at arm's length. Price may differ, because the product may differ, business functions may differ, the terms and conditions may differ, market conditions may differ, or business strategies may differ. The difference between the two prices may indicate that the conditions of the commercial and financial relations of the associated enterprises are not at arm's length. The differences have to be adjusted in order to secure parity between the controlled and the uncontrolled transactions.

Adjustment of profits by reference to the conditions available between independent parties under comparable circumstances suggests parity between associated and independent enterprises. This would mean that the arm's length principle is based on the hypothesis that members of an MNE group (associated enterprises) operate as separate entities rather than as inseparable parts of a single unified business, at par with independent enterprises with no advantages because of the same or common control. In the absence of such adjustment relative competitive positions of the related and unrelated enterprises would be distorted. To avoid such distortion and in order to promote growth of international trade and investment, such adjustment of profit is necessary to offset the advantage arising only because of being a member of the same group.

Article 9(1) though allows tax authority to make an adjustment to the profits as reported in order to bring them for purposes of taxation to what is briefly described as arm's length profit, there is nothing in that article how the tax administration would go about ascertaining arm's length price in order to arrive at arm's length profit.

Commercial or financial relations - Arrangements

The commercial and financial relations between the associated enterprises may take the form of arrangements so that benefits are provided to other members of group for no consideration.

Thus, the application of the principle of arm's length requires comparison of conditions in a controlled transaction with the conditions in an uncontrolled transaction for any difference between the two situations, and adjustment of profits to offset the effect of any such difference. To be comparable means—

- that none of the differences between the two situations could materially affect the conditions being examined in the methodology (*i.e.*, price or margin) or
- that reasonable adjustment can be made to offset the effect of such differences, if any.

Whether there is a comparability between the two situations compared, one has to look for the differences. Comparability exists, if there is none, and achieved if eliminated by way of adjustment to offset their effect.

Associated enterprises - Arm's length price determination - Comparable uncontrolled price method

15.8-1 The market price of the same or similar goods has to be found out in an open uncontrolled market. It is done by reference to the prices charged on comparable arm's length transactions *i.e.*, the price at which the same kind of inventory is sold/purchased by unaffiliated parties under the same and similar conditions.

Associated enterprises - Arm's length price determination - Resale or resale minus method

15.8-2 This involves subtracting a mark-up from the price at which the goods were sold to independent customers. Or if the resale price is the price at which the goods which have been purchased from a related company is sold to an unrelated company. A normal mark-up for profit to be earned by the re-seller is determined based on the gross profit percentage of the sale of the same or similar goods which was purchased from and sold to by a comparable re-seller unrelated companies. This method, therefore, requires deduction of a mark-up from the price received by the associated buyer for sales by that associated buyer to independent third parties.

Associated enterprises - Arm's length price determination - Cost plus method

15.8-3 This involves determination of the cost of the goods to the vendor and to this added a normal mark-up for profit to be earned by the supplier. It consists adding a mark-up to the cost of the associated suppliers.

Associated enterprises - Arm's length price determination - Fourth method (and comparable profit method)

15.8-4 In case none of the aforesaid methods is appropriate, any other as appropriate to the facts of the case may be followed. The methods under this category are now more precisely categorised, recognising in particular a comparable profit split method and a more general class of "unspecified methods". Neither of these relate to determination of the arm's length price. They relate to determination of an arm's length profit. Profit method consists of:—

- comparable profits method;
- comparable profits split method;

■residual profits split method.

All these look to transactions between uncontrolled parties. The first looks to the profits made in similar transactions ; the second, to the manner in which the total profit on a series would be split between them; the third, to the functions performed and risks assumed and attribution to each function and risk the rate of return which would be received for comparable functions and risks. The comparable profits and split are the methods of last resort. They are not very reliable.

Associated enterprises - Arm's length price determination - Choice of the method

15.8-5 Uncontrolled price method is normally favoured to arrive at the arm's length price, under the anti-avoidance legislation. It is followed by the resale price method, and then the cost-*plus* method, and then the fourth, if none of them is appropriate. The reason for such order of priority lies in the comparative reliability. The uncontrollable price method comes closest to the actual price in the market place. Resale price method is preferred over the cost-*plus* method in that it approximates the market price. Two figures for each method are required to be ascertained. In the latter, both depends on estimation (the sellers' cost and the sellers' mark up). In the former, only one is to be estimated (resellers' mark-up) as the other is fixed by the open market (the price at which the goods are resold by the related purchaser). The US regulations, however, have abandoned the strict order of priority and accept the use of the best *i.e.*, the most reliable measure of arm's length result. The best method means the method that produces the most reliable results. Factors that are to be considered in determining reliability include comparability, completeness and reliability of available data, and confirmation of results by another method. Generally, a separate transaction approach is used to evaluate transfer pricing. However, transactions involving similar products or services may be aggregated where aggregation would lead to a more reliable result. The emphasis is on the reliability of the result.

Associated enterprises - Arm's length determination - Uncontrolled price method is the most favoured

15.8-6 Uncontrolled price method is the most favoured, as it attempts to approximate the market.

To curb the abuse of transfer pricing the arm's length method is the most favoured of all others adopted by respective country, as it attempts to approximate the market. This method is ideally suitable for commodities which are subject-matter of frequent trade in the open market. When such commodities are the subject of transactions between the two related parties, open market price may provide a ready reference to testify whether these transactions are dictated by considerations normally found between two parties dealing at arm's length, or these are controlled or influenced by intra-firm relationship. However, for intra-firm dealings in semi-finished, intermediate or capital goods, the difficulty may arise because of the absence of the general availability of the open market price for those or similar goods. Estimation of the price on the hypothetical supposition of the existence of an open market and a willing purchaser and a willing seller may pose a problem. As there could be *bona fide* difference of opinion about the estimation of open market price, because reasonable people acting fairly, reasonably and objectively may arrive at figures which vary considerably from each other, the formulation of such estimate has to be made with some care and caution. For that, attempt be directed to estimate the open market price under the resale price method or the cost-*plus* method or any other available method. If there is not much of difference between the figures arrived at, average would represent as approximating the open market price. Or, in the alternative, a more manageable and expeditious means of resolution of the market price may be found out, especially when stakes are high.

Associated enterprises - Arm's length determination of services

15.9 Determination of price at arm's length for transfer of intangibles such as services, patent or copyrights poses a difficulty inasmuch as comparable price in the open market for the same or similar services or rights is not normally available. Such difficulty may not be so prominent, when the service provided is of commercial and technical in nature. It is possible in that case to establish an arm's length charge by reference to the amount charged between unrelated parties for similar services. But if the service is neither commercial nor technical, but somewhat specifically performed for the benefit of the affiliate, such as special marketing surveys, financing studies, advertising, employee training services, special legal and management consultant services, comparable open

market transactions are rather impossible to find out. In that situation, it is proper to determine the cost to the parent company in supplying or performing the services. To this be added profit mark-up appropriate, when the services form an integral part of the business of the parent, and not where it is not so. However, the tax authorities should look through the transaction with care to see whether the charges for services are imposed on the subsidiary merely as a device of withdrawing profits from it first as a direct charge and subsequently as a constituent of the price of goods sold to the subsidiary.

Associated enterprises - Arm's length price determination - Right to use patent

15.9-1 Normally the right to use the patent or other intangible right is transferred for a consideration, charged as lump sum or based on turnover/production or both. Whether such consideration is reasonable and approximates open market place especially when the parties to the transaction are related has to be determined under the arm's length approach in a manner similar to the one adopted for determination of price for goods or services. A scrutiny of agreements between the licensor and the unrelated parties under similar transactions under similar circumstances involving the same and similar intangible property, would indicate about what the open market price for the intangible is. However, if such transactions are absent, reliance has to be placed on various factors which are determinants of a free market price, such as prevailing royalty rates, nature of the patent or other intangible prospective profits to the licensee, and the costs to the licensor. The most important of all these factors is the prospective profits to the licensee. The earning capacity of an asset is the criterion which is normally resorted to in the absence of transaction for similar or same goods under similar or same condition to determine its market value.

The Committee on Fiscal Affairs of the OECD in its report of 1995 (published in 1996) dealt with pricing of intangibles and intra-group services. It emphasised difficulties in comparing the prices of branded goods with those of the generic goods and goods bearing a different brand name. It also emphasised the problems of pricing where valuation is highly uncertain. The solution lay not on such uncertain determinants. It lies in a hypothesis; what independent enterprises would have done in comparable circumstances at the time of the transaction without using the hindsight, with a proviso. Royalty agreements could in some circumstances be adjusted in the light of unforeseen fundamental developments.

Associated enterprises - Arm's length pricing determination - intra-group services

15.9-2 In determining the arm's length price with respect to intra-group services, the hypothesis to be applied is what a comparable independent enterprise would be prepared to pay for that service in comparable circumstances. While doing so, the cost to the service provider is also to be taken into account. Intra-group services include :

- the operation of a Group debt-factoring centre;
- contract manufacturing;
- contract research and development;
- the administration and enforcement of the intangible property rights (as distinct from exploitation).

Associated enterprises - Arm's length price determination- E-commerce

15.9-3 A large share of the trade consists of transfer of goods, intangibles and services within the multinational enterprises. To determine their taxability in each jurisdiction the right price (the arm's length price) has to be put on those transactions. Arm's length principle as set out in article 9 aims at ensuring transfers within a group approximate to those which would be negotiated between independent firms.

An analysis under the arm's length principle generally requires information about the associated enterprises involved in the controlled transactions, the transactions at issue, the functions performed, and information derived from independent enterprises engaged in comparable transactions. Notwithstanding a lack of adequate and relevant information, tax administrators are still confronted with the need to make a determination of arm's length transfer pricing in cases where information available is incomplete. Technological changes and financial deregulation have dramatically globalised financial markets. Electronic commerce provides a fundamentally new way of conducting commercial transactions. This does not present fundamentally new or categorically different problems for transfer pricing, though has made difficult the application of the traditional transfer pricing methods. The basic nature of the problem has not changed. As a result of the nearly instantaneous transmission of information and the effective

removal of the physical boundaries, it may become more difficult for tax administration to identify, trace, and quantify cross-border transactions and to apply traditional methods of transfer pricing. The difficulty lies in:—

- applying the transactional approach;
- establishing comparability;
- applying traditional transaction methods;
- taxation treatment of integrated business.

The same difficulty will also arise in connection with the attribution of profits to permanent establishment in an electronic commerce environment, especially as to whether the current rules in article 7 produce a desirable result.

The traditional transfer pricing approach as set out in the guidelines in the 1979 transfer pricing report was substantially revised in 1995. The revised guidelines are also inadequate for resolving transfer pricing difficulties arising from complexity of cross-border transactions, the proliferation of the MNEs, and the difficulty in finding comparable market transactions to price controlled transfers. The traditional method, *viz.*, the following were found insufficient, because they relied heavily on accessing relevant data about comparable transactions between independent parties :—

1. Comparable uncontrolled price (CUP);
2. Cost-*plus*; and
3. Re-sale price.

Methods 2 and 3 above are based upon gross profit margins.

New methods were introduced in an effort to handle more complex cases including those with intangible property. Based on comparison of net profit margins, comparable profits method was introduced. That method is also insufficient.

The OECD has not devised any new method. The following is the approach :—

- To preserve the arm's length principle as the most effective means for dealing with transfer pricing, but
- To interpret it broadly to permit a country to apply non-traditional methods though as a last resort, with strict limitations. (The idea of using non-traditional methods is not new and as its origin in the discussion of the fourth "any other method" approach described in Chapter 1 of the 1979 OECD Transfer Pricing Report.)

The non-traditional methods would have to be applied in a manner that would safeguard the integrity of the arm's length principle. The insistence of transactional approach and a more thorough comparability analysis followed from this reasoning.

The traditional transfer pricing approach depends upon the transactional and comparability principles. It has two-fold characteristics as elaborated by the OECD's 1995 consensus on transfer pricing. These are :

1. The requirement for the transactional approach, and
2. The need to establish comparability between the controlled and the uncontrolled transactions.

The Guidelines prefer use of the transactional method which is based on establishing the said comparability. If there is difficulty in applying it, methods of last resort (*e.g.*, profit split method) are used.

Transactional approach

The speed, frequency, anonymity and integration over the internet and the development of the intranets within the MNEs may make it harder to apply a separate transaction analysis. The greater integration of the business activities may mean there is a greater need to consider sets of related party transactions rather than to consider each transaction separately. An MNE may disperse functions related to a particular economic activity around the world. Evaluation of the dispersed functions is required to be made. It is difficult in practice, especially where the functions, although geographically separate, are economically linked to other functions and contribute to an integrated business activity. Greater mobility and integration add to the difficulty of attaching particular activities to particular jurisdiction. Where the transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis, aggregation has to be done. Thus, aggregation is permitted where the transactions are closely linked or continuous. Transactions in electronic commerce mostly relate to the second category. Continuity, as well as the close linkage among the transactions, is common in the area of innovative financial transactions, *e.g.*, global trading. The phenomenon of global trading is the result of technological change and

financial deregulation which have dramatically globalised financial markets. Financial firms have organised themselves to sell financial products 24 hours a day. This phenomenon challenges taxpayers and tax administrators to come with a fair way of allocating and taxing the profits in each country where the global trading is carried on. The OECD has published in April 1998 a considerably revised and updated version of the discussion draft, "The Taxation of Global Trading of Financial Instruments". The publication, though analyses the challenges posed to traditional taxation methods and discusses a range of policy options to tackle the problems relating to a specific industry sector, is also relevant for other sectors as the way they conduct their business changes as a result of the spread of globalisation and electronic commerce. Of particular importance is the global integration of functions and intensive co-operation between different geographic locations. In global trading the profit split method is often suggested as the most fitting solution to deal with the most complex cases where the global trading activities are highly integrated amongst business functions and locations. The same may be applied to other industries.

Comparability analysis

The concept of establishing comparability is central to the application of the arm's length principle. It links that principle to the operation of arm's length transfer pricing methodologies. The standard of comparability is determined by the availability and extent of reliable data on which comparison is made with the uncontrolled situations and dealings for a particular case. In the context of electronic commerce, it becomes more difficult to identify the individual transaction. It is more difficult to find out enough about any third party transactions to conclude that they are comparable. The standard of comparability, therefore, becomes difficult to be satisfied.

Functional analysis

Functional analysis is an analysis of the functions performed (taking into account of assets used and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions. It can assist in the selection of the transfer pricing methodology by revealing nature and characteristics of the related party transaction; in the analysis of the level of comparability present in controlled and uncontrolled transactions when a traditional transaction method or a transactional net margin method is used; and in an assessment of the relative contributions of the parties when a profit split method is used.

Functional analysis is difficult not only in the assessment of function but also in the making of adjustments that account for the difference, when the involved electronic commerce transactions are complex and unique. How to allocate the functions performed by a computer, is the question. For example, how much function can be attributed to the ownership of the computer server and software, the development and adaptation of the original software, or the programming of the computer etc.

Method of last resort

As discussed above, there could be difficulty in applying the traditional transactional methods on which the Guidelines have put priority. Methods of last resort, then, may be used (*e.g.*, profit split method). Once it has been decided to use the profit split method, it is essential to determine what profits are to be split. The question is :—

1. which activities and
2. what revenues

related to electronic commerce should be taken into account.

The first issue relates to whether the activities that have remote connection with the electronic commerce activities should share in the profits. The second issue relates to what revenues and expenses are relevant for determining the profits derived from the electronic commerce activities, which involve the identification of all locations providing input into the electronic commerce activities.

Associated enterprises - Arm's length price determination and the Income-tax Act

15.10 The Indian Law on transfer pricing was enacted by the Finance Act, 2001, which is discussed in detail in Chapter 53. The existing section 92 was substituted by new sections 92, 92A, 92B, 92C, 92D, 92E and 92F. The old law as contained in section 92 is discussed in the following paragraphs, the principles of which are still relevant as propounded by decisions of courts. The Income-tax Act contains provisions to prevent the abuses associated with the transfer of profits through the agency of payment as commission or interest or through any transactions between the related parties. Thus, where an assessee incurs expenditure in respect of which payment has to be made to any related persons the amount to the extent it is excessive and unreasonable is not allowed deduction -

Upper India Publishing House (P.) Ltd. v. CIT [1979] [117 ITR 569](#) (SC). The mere existence of agreement between the two parties about the sale of consideration for the supply of goods or services does not mean that the income-tax authorities have no discretion but to accept and to hold that the payment has been made wholly and exclusively for the purposes of business. Although payment may have been made and there might be a valid agreement or contract, it is still open to the authorities to take into consideration all the relevant factors to show whether the payment made is wholly and exclusively for business purposes - *Swadeshi Cotton Mills Co. Ltd. v. CIT* [1967] [63 ITR 57](#) (SC) and *Lachminarayan Madan Lal v. CIT* [1972] [86 ITR 439](#) (SC) viz., the normalcy of the expenditure having regard to the practice in the trade, the existence of any other extraordinary and abnormal circumstances in the arrangement or special reasons or circumstances which may suggest that the transaction was abnormal and the like. The business expediency should be the criterion for the expenses. In applying this test however, reasonableness of the expenditure has to be adjudged from the point of view of the businessman and not of the income-tax department. The department can however come to the conclusion that either the alleged payment is not real or that it is not incurred by the assessee in his character of a trader or it is not laid out wholly and exclusively for the purpose of the business of the assessee, and to disallow it - *J.K. Woollen Mfrs. v. CIT* [1969] [72 ITR 612](#) (SC), *Bengal Enamel Works Ltd. v. CIT* [1970] [77 ITR 119](#) (SC) and *CIT v. Walchand & Co. (P.) Ltd.* [1967] [65 ITR 381](#) (SC). Expenditure in regard to colourable or sham transactions transacted with a view to appropriating the funds of a flourishing concern to their own use by those who control the assessee and its affairs, cannot be allowed deduction - *Madhowji Dharamshi Mfg. Co. Ltd. v. CIT* [1970] [78 ITR 62](#) (SC) and *Shapurji Broacha Mills Ltd. v. CIT* [1970] [78 ITR 68](#) (SC). If the circumstances indicate that the expenses as incurred are not dictated by commercial expediency but are inspired by profit-hunting motive, because of the close relationship between the parties to the transaction, such expenditure cannot be allowed as deduction - *J.K. Cotton Mfrs. Ltd. v. CIT* [1975] [101 ITR 221](#) (SC).

The Income-tax Act makes provisions to enable the tax authorities go behind the arrangement between a resident and non-resident to find its real intention and substance as to whether such an arrangement is intended to divert income as if arising or accruing at a place different from where it could have normally arisen or accrued but for such arrangement. These provisions are contained under Chapter X, in section 92 (income from transactions with non-residents, how computed in certain cases has since been substituted); section 93 (avoidance of income-tax by transactions resulting in transfer of income to non-residents); section 94 (avoidance of tax by certain transactions in securities). The old section 92 specifically proclaims the concept of transactions at arm's length and echoes the uncontrolled price method concept in the Indian context.

The old section 92, therefore, provides that where a business is carried on between a resident and a non-resident and it appears to the Assessing Officer that owing to the close connection between them, the course of the business is so arranged that the business transacted between them produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business, the officer shall determine the amount of profits which may reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident. Section 94 consists of two limbs. The first, prescribes the condition on which charge arises, viz., there should be a business as carried on between the resident and a non-resident, the course of business is so arranged as to produce no profits or produce less than the expected profits. Such arrangement has been made possible because of the close connection between them and this arrangement may be responsible for no profits or reduced profits in the opinion of the Assessing Officer. The second limb imposes the charge; empowering the officer to determine the amount of profits which may reasonably be deemed to have been derived therefrom and then to include such amount in the total income of the resident assessee. The expression 'profits in the charging part of the enactment is associated with the words which may reasonably be deemed to have been derived' and this association has its origin in the preceding clause 'produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business'. The word 'therefrom' has reference to business and it is this business, therefore, that is the subject of charge under section 92. To construe that the word 'therefrom' has reference to the arrangement between the non-resident and the resident, would on the grammar of it, be untenable and it is impossible to conceive how an arrangement relating to the conduct of business can, as such, be the subject-matter of income-tax apart from the business in which profits and gains are made - *Mazagaon Dock Ltd. v. CIT/CEPT* [1958] [34 ITR 368](#) (SC).

However, in case when evidences have been circumstantial or inferential appear leading to reasonable belief that export price has been depressed or import price inflated, or there has been undercharging or overcharging the

normal price, the Assessing Officer may proceed to make assessment to the best of his judgment, in terms of section 145.

The words 'profits', 'have accrued to one of the enterprises' thus similarly convey that the enterprise must be carrying business or profession the income of which is taxable in its hands, and the commercial transactions between the two enterprises are controlled or managed in such a manner as to cause variation in the profits of the aforesaid enterprise which could not have been possible had these two enterprises been not thus associated. Commercial or financial relations between the two enterprises as such cannot be subject-matter of income-tax, apart from the business or profession in which profits and gains accrue or are made. The depression of profits could be effected through various transactions relating to sale or purchase of goods, services, grant of commission rebates, masquerading equity financing and thus distributing dividend in the form of interest, etc.

1 *Article 9 of the OECD Model and section 92* - The old section 92 of the Act and the article in tax agreements empower the tax authorities to ascertain whether the relationship between the two enterprises has diverted the course of carrying on business or profession from the normal course as to prevent profits from accruing. This authority extends to all cases in which either by design or inadvertence taxable profits in whole or in part of an affiliate is other than what it would have been had the transaction dealt at arm's length. However, while dealing with such assessee, the authority should not entertain a confusion between 'arm's length' and 'fair prices'. The former relates to the control of internal prices and the latter is part of antimonopoly measures.

1 *Indian courts' approach* - But even without section 92 or the article in the tax agreements, the courts in India have been upholding the revenue's right to disregard any device practiced by the assessee towards payment of legitimate taxes which would have become due to it but for such devices. If by reason of transaction the business is reduced so as to divert the profits which the person would otherwise have received, and if such a transaction is affected with the dominant object of avoiding or reducing the liability, it would be competent of the tax authorities to go behind the transaction and assess the profit which might have been received by the person but for the transaction. - *Karumuthu Thiagaraja Chetty & Co. v. CEPT* [1961] [42 ITR 788](#) (Mad.). The traditional approach of maintaining the assessee's right to arrange its fiscal affairs in a manner so as to reduce tax burden has been eroded considerably during the recent years. If the parties have chosen to conceal by a device the legal relation or the nature of the transaction, it is open to the taxing authority to unravel the device and to determine the real character of the relation or the transaction - *CIT v. Gillanders Arbuthnot & Co.* [1973] [87 ITR 407](#) (SC) and *Juggilal Kamlatpat v. CIT* [1969] [73 ITR 702](#) (SC).

The courts have upheld the revenue's right to disregard transaction and look upon its substance, if it is undertaken as an anti-avoidance tool. The tax consequences of the interlocking, interdependent and predetermined transactions are to be judged by reference to its substance. A preordained series of transactions into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable, have to be ignored and the authorities could look to the realities and tax that amount of income which is intended to be escaped or shifted through such devices - *McDowell & Co. Ltd. v. CTO* [1985] [154 ITR 148](#) (SC), *W.T. Ramsay v. IRC* [1982] AC 300 (HL) and *Furniss v. Dawson* [1984] AC 474 (HL).

In determining whether the transaction is genuine, the courts will have to consider all surrounding circumstances, including the economic purpose of the transaction and the question whether or not there is a tax avoidance motive behind it. The acts which dissimulate the true nature of a contract or of an agreement under the appearance of provision giving rise to or disguising either a realisation of a transfer of profits or income or permitting the avoidance of taxes are not valid against the tax authorities. In order to set aside the acts of an assessee as being ineffective, such acts should have a fictitious character, or, if not, these have no other motive than to avoid or alleviate the tax burden which the assessee, if he had not carried out these acts, would normally have had to pay having regard to his actual situation and activity.

Section 92 has since been substituted by new provision, containing Indian law relating to Transfer Pricing. It is discussed in detail in Chapter 53.

Associated enterprises - Arm's length price determination - Relief from taxation

15.10-1 In case, however, there is variation in the computation of profits on the basis of the estimation of open market price and by applying the doctrine of arm's length price, or where a part of interest has been disallowed on

the ground that such payment (disguised dividend) is made as interest because the equity capital was hidden as borrowed capital, such inflation of profit be not subjected to tax doubly, once in the country of the source and again where the profit is intended to be shifted. Normally, tax agreements take care of such a situation. But even where the agreements providing for corresponding treatment do not exist, the recipient country should give relief for any double taxation of profits or of interest as if the payment is in fact dividend. This is based on the principle that the application of the rules designed to deal with hidden equity capitalisation should not normally increase taxable profits of an enterprise to an amount greater than the profits which would have accrued in an arm's length situation. The recently concluded agreement between India and Kenya contains the provisions to this effect.

In case provision similar to the one referred to in Kenya does not exist in a treaty the national tax authorities should decide through mutual agreement for the elimination of double taxation. Where, however, no treaty exists, the domestic tax laws should be flexible as to provide itself unilaterally.

Paragraph 2 of the Article provides for such relief. The rewriting of transactions between associated enterprises on the basis of the arm's length principle, may give rise to economic double taxation, *i.e.*, taxation of the same income in the hands of the different persons. An enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which as already been taxed in the hands of its associated enterprise in State B. paragraph 2 provides that in these circumstances, State B shall make appropriate adjustment so as to relieve the double taxation (*see* paragraph 5 of the OECD Commentary on Article 9). That paragraph would, however, will not apply if the actions giving rise to an adjustment of profits is held to be on account of fraud, gross negligence or wilful default (*see* paragraph 3).

Associated enterprises - Relief from taxation - Secondary adjustments

15.10-2 When an upward revision of profits are made in accordance with the arm's length principle, the other State will have to make adjustments to the amount of tax charged therein on those profits. When such adjustment has been made, the enterprise (say Y) in that other State is found in possession of funds and are not restored to the other enterprise (say X). Though the other State may provide for adjustment of taxes in terms of paragraph 2, the question arises as to how to treat those funds in the hands of Y, if not restored. Such funds are usually treated as a dividend (or royalty) or contribution to capital, depending upon the relationship between the two parties. They are treated as dividend if enterprise Y were the parent of enterprise X or loan if X were the parent of Y. In that case, there would have been other tax consequences, *e.g.*, the operation of withholding tax., depending upon the type of income and the provisions of the Article dealing with such income. (*See* para 87 of the OECD Commentary). Paragraph 9 of OECD Commentary on Article 9 provides that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of the Contracting State.

Transfer pricing - Customs Act

15.11 The valuation of international transactions for the purpose of Income-tax Act and customs duty is done on the same principle, at arm's length price. Yet, the process and the purpose may be different. There is no legal link between the customs valuation and valuation of goods for purposes of transfer pricing in income-tax. Customs duty are concerned with the economic value conveyed, whereas the income-tax, with the economic value added. The taxable event for income-tax is the purchase, sale or lease of the property or the provision of services, and for customs duties, the importation of goods. Different considerations prevail for determining the transfer pricing under the Customs Act. Under that Act, it is the value conveyed while under the Income-tax Act it is the value added for income-tax the method applied is comparable uncontrolled prices and for customs duties, the transaction value method. The transaction value, *i.e.*, the value conveyed, may be entirely different from the value added. The difference is illustrated by referring to the decision of the Supreme Court in *State Bank of India v. Collector of Customs* [2000] 1 SCC 727/1 Scale 72. The bank, in that case, had, under an agreement with the foreign company, imported a computer software and manuals, the total value of which was US dollars 4,084,475. The bank filed an application for refund of customs duty on the ground that the basic cost of the software and manuals was US dollars 401,047. While the rest of the amount of US dollars 3,683,428 was payable only as a licence fee for its right to use the software for the bank countrywide. The claim of refund was not accepted by the Supreme Court as in its opinion duty was payable on the transaction value determined and in determining it there has to be added the price actually paid or payable for the imported goods, royalties and the licence fee for which the buyer is required to pay, directly or indirectly, as a condition of sale of goods to the extent that such royalties and fees are not included in

the price actually paid or payable. When technical material is supplied whether in the form of drawings or manuals the same being goods is liable to customs duty on the transaction value in respect thereof.

The Supreme Court in another case, *Associated Cement Companies Ltd. v. Commissioner of Customs* [2001] 4 SCC 593/124 STC 59 observed "the value of the goods imported would depend upon the quality of the same and would be represented by the transaction value in respect of the goods imported." The transaction value "in respect of the goods imported" is entirely different from the classic concept of the price "of the goods". The price of the goods of the computer software, in the case of *State Bank of India v. Collector of Customs* [2000] 1 SCC 727, was US dollars 401,107, while the transaction value US dollars 4, 084, 475 which included licence fee of US dollars 3,683,428 for the right to use of the software. The licence fee was the value in respect of the software imported and not its price, *i.e.*, US dollars 401,107. For the purposes of income-tax both are given separate treatment, one of the revenue and the other of capital nature.

The price for transaction between members of the multinational enterprise is fixed, for the purpose of income-tax, to avoid income and for the purpose of custom duties, to alter the pattern of international trade. The aims of the two departments are also different. Of the income-tax, it is to reduce the value of the imported goods or services so as to reach a high taxable base, and of the customs, to increase so as to increase the yield. There is also dissimilarity in the methods of valuation. For income-tax, the method applied is the comparable uncontrolled prices; and for custom duties, transaction value method. Simple application of the two different procedures lead to different results.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT – DIVIDENDS

ARTICLE 10

DIVIDENDS

1. *Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.*

2. *However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed :*

- (a) *. . . per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;*
- (b) *. . . per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.*

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. *The term "dividends" as used in this article means 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.*

4. *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.

5. *Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.*

Introduction

16.1 Tax treaties comprise agreements between two countries. The aims include eliminating international double taxation, promoting exchange of goods and services (business or profession), encouraging movement of capital (investments) and persons (salaries and pensions). Income generating all human active and passive activities are covered. Activities and investment are the two main sources of income. In the first falls income derived from business, independent and dependent personal services, agricultural and forestry; and in the second, dividends, interest, royalties and income from immovable property. The primary right of the source state to impose tax on income arising from the activities of the first category or the location of the immovable property has not been in dispute and is conceded in all tax treaties. As regards income from investments, there are competing claims. Income from capital and services by way of dividends, interest or royalties is the result of the cooperation of capital and services with the infrastructure of the source country. Capital and the services are contributed by the residence country and the management, labour, work, efforts by the source country. Insistence upon the taxability of such income by the state of which the provider of capital or services is resident and also by the source country which is the provider of labour, infrastructure and the base for the generation of income has led to the modification of the rule of exclusivity of taxation by the country of residence or of source. Double taxation is avoided in tax treaties by allocating taxing rights between the residence and the source states by requiring the former to eliminate double taxation where there are competing taxing rights. The tax treaty thus provides a compromise, conceding rights of both to share.

The tax treaties allocate jurisdiction of the source state, it retain a fixed percentage of the gross income earned by a non-resident as dividends, interest and royalties, known as withholding tax in international parlance. The withholding tax rate is limited. Even such withheld tax is to be credited against the residence country tax. The restriction to a limited withholding tax is lifted if the recipient has, and the income is effectively connected with, permanent establishment. In that case the source state has full right to tax the entire income as business income of that establishment. The reason is obvious. An enterprise may engage in trade or business in a foreign country either through a branch (permanent establishment) or through a subsidiary. As a rule the computation of income of the branch office and the rates of tax are in principle the same as for the domestic corporations. Profits transferred by a branch office to the foreign corporation are not subjected to withholding tax. Since the branch office is not regarded as a legal entity separate from its "principal", its profits are included in the profits of such principal for the purposes of taxes in the residence country. In case where a corporation chooses to establish in a foreign country a subsidiary company the difficulty would arise because such a company is an entity independent of the principal. The dividend from the subsidiary company is to be taken as the income of the principal. It suffers tax in the residence country. It also suffers tax in the source country to the extent of the withheld tax. The subsidiary company has also paid tax on its profits in the source country. The combination of the corporate tax on the profits of the subsidiary company and the withheld tax on the dividends repatriated to the principal company is apt to exceed the tax payable by the latter on the same amount of income from the operations within the country of its residence. The rates of withholding tax have to be tailored to such a reasonable extent that there is no significant extra burden constituting a barrier to capital movement and interfering with international tax resources. The impact of direct investment would, therefore, be that withholding tax on dividends is reduced often to 15 to 5 per cent (sometimes depending on the percentage holding in the company paying the dividends), and on interest also reduced.

Article 10 provides the rules for taxation of dividends paid by a resident of one of the contracting State to the resident of the other contracting State. It provides for a full residence country taxation of such dividends and a

limited source- State right.

Article 10, therefore, deals with distributive rule regarding taxation of dividends income. It determines which state will have the right to tax it and how much. The article grants taxing rights to both the contracting states. It provides a reduced withholding tax on dividends paid from one contracting state to a resident of the other and further lower (typically 15 per cent to 5 per cent) if the recipient of the dividend satisfies a minimum ownership threshold from 10 to 25 per cent of the corporate's stock. Thus, article 10 makes a distinction between the portfolio and direct investments by reversing the position. It provides that dividend may be taxed in the state in which the paying company resides. It, however, limits the rates of withholding tax both as regards to portfolio and direct investment. The competent authorities may settle by mutual agreement the mode of application of the limitation as laid down in paragraph 2. Paragraph 3 defines the expression "dividend". Paragraph 4 excludes the applicability of the article in a situation where the recipient of the dividend has permanent establishment or the fixed base in the country of the paying company. Paragraph 5 limits the liability of a country to tax dividends by non-resident countries. Such dividends are not subject to any taxation effects in the other state unless they are actually received by a resident of that state.

Dividends - Residence State right to tax

16.2 Paragraph 1 provides that the resident state of the recipient of the dividend may tax the income. That right is, however, not exclusive, as the use of the expression "may be taxed" suggests. It leaves open the possibility of taxation by the state of which the paying company is resident. If it is taxed by both the states, the relief could be granted in terms of article 23, to avoid double taxation.

The Article 1 deals with dividends paid by a company which is resident of a contracting State to a resident of other Contracting State (paragraph 1). It does not, therefore, apply to dividends paid by a company which is resident of a third State or to dividends paid by a company which is resident of a Contracting State which are attributable to a permanent establishment which an enterprise has in the other Contracting State (*see* paragraph 8 of the OECD Commentary on Article 10). The emphasis is on the word "paid".

Dividends "paid"

16.2-1 The applicability of Article 10 arises only when dividends are "paid" by a company which is resident of a Contracting State to the resident of the other Contracting State. The concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required under the contract or by custom (*see* paragraph 7 of the OECD Commentary on Article 10). The Supreme Court in *Benaras State Bank Ltd. v. CIT* AIR 1970 SC 281, held that the expression "paid" should be given a wider meaning and should not be confined to the actual payment, it also means where the amount is unconditionally made available to another person. The tax is withheld by the source State in terms of paragraph 2 only when the dividend is paid.

The meaning of the expression "dividends paid ...to a resident of the other Contracting State" used in paragraph 1 is clarified in paragraph 2 which requires the recipient to be the beneficial owner of dividends. The requirement of beneficial ownership makes it plain that "the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention" (*see* OECD Commentary, article 10, paragraph 12). The word "paid" as aforesaid, means putting funds at the disposal of the shareholder. The income is placed at the disposal of the beneficiary through the conduit of agent or the nominee. The recipient who nominally receives has no right or control over the income, which in reality belongs to the actual owner of whom such recipient is the agent, nominee, or the conduit. The income belongs to the beneficial owner and, therefore, said to have been paid to him.

Dividends - Source State right to tax

16.3 The company paying dividends may be resident of one Contracting State, while the recipient, of another. Recipient's state (residence state) may tax it as per paragraph 1; paying company state (source state) may also do as per paragraph 2, which, however, lays the limit and the condition. It limits the rate of withholding tax to 15 per cent of the gross amount of dividends as per OECD model. The UN model leaves the percentage to be established through bilateral negotiations. The rate of withholding tax could be still lower (5 per cent as per OECD model, and as negotiated as per UN model) on the condition of the recipient company holding directly at least 25 per cent (10 per cent in the UN model) of the capital of the company paying dividends. Paragraph 2 demands that the recipient be the beneficial owner of the dividends in order to have access to the reduced withholding rate of tax which are two in number. One rate is applicable to portfolio investment; and, the other, a still lower, for direct investment.

The OECD model prescribes the minimum ownership threshold of 25 per cent (the UN model 10 per cent) of the paying company stock to decide the direct investment from the portfolio. Thus the OECD model prescribes the rate of 5 per cent for direct investment (25 per cent qualifying holding) and 15 per cent for portfolio; the UN model leaves the percentage to be established through bilateral negotiation and suggests the qualifying holding at 10 per cent rather than 25 per cent. The advantage of a reduced rate of tax in the source country is meant to be dependent on the beneficial ownership of the dividend being vested in the resident of the other country to whom it accrues. The OECD model was amended in 1995 by substituting, for "if the recipient is the beneficial owner of the dividends", the words "if the beneficial owner of the dividends is a resident of the other contracting state". The competent authorities of the contracting states shall by mutual agreement settle the mode of application of these limitations.

Dividends - Withholding rates of tax and the UN model

16.3-1 While the OECD model places a ceiling on withholding tax at five per cent of gross amount if the recipient is a company which holds 25 per cent of the capital of the company paying dividends, and at 15 per cent in all other cases, the UN model leaves it to be decided through bilateral negotiation, though the minimum holding of the recipient company has been laid at 10 per cent in place of 25 per cent. The influencing factors for the determination of the percentage to be negotiated bilaterally are :—

- ◆•Rates of taxes levied by the source country on the corporate profits;
- ◆•Rates of the taxes levied on the income which the investor derives as dividends;
- ◆•The tax treatment of the foreign income in the resident country as also the character of double taxation relief offered by it, whether the credit or the exemption method;
- ◆•Whether limitation of the withholding tax benefits the international investor, since the basic purpose of the limitation is to remove barriers to the movement of the capital, as also to reduce the effective rate of the source country to the credit level of the residence country.

While laying down the rates, the objective to be kept in view is that under no circumstances should the total tax on a given portion of company's income be higher than that would have resulted by the application of the higher of the tax rates of the contracting states, *i.e.*, there should be tax neutrality (Tax neutrality envisages that the business decisions can be reached independently of tax system). The tax rates should be effective rates in the sense that incentives offered by a state are taken into consideration and the tax thereby spared. The withholding tax to be levied by the source country should be such as that if the residence country uses the tax credit system, it in combination with the corporate tax rate does not exceed the tax in the residence state. The corporate tax rate means the effective tax rate.

Dividends withholding tax - Treaty access, conditions

16.4 For treaty access an entity must be first a person, secondly, resident, and thirdly, beneficial owner of the foreign income received. The reduced rate of withholding tax in terms of paragraph 2 is applicable if the recipient of the dividends fulfils these requirements. As for the first requirement article 3 refers. A person includes an individual, a company and any other body of persons, and a company means any body of corporate or any entity which is treated as body corporate for tax purposes. The India/US treaty also includes an estate, a trust, a partnership.

As for the second requirement, article 4 refers. A person is resident in a state if it (a) is liable to tax in that state, (b) by reason of its domicile, residence, place of management or any other criterion of similar nature, and (c) in respect of income whatever sources and capital wherever situated. On the meaning of "liable to tax", the treaties do not normally concern themselves with the domestic laws of the concerning states laying down the conditions under which a person is to be treated fiscally resident and consequently, fully liable to tax in that state. A person may be taxable entity (*i.e.*, a person for tax purposes in its country of residence), it still does not actually pay tax. This is either because it is exempt from tax or because it obtains deductions so that the tax liability is reduced to *nil*.

But besides being resident, the person has to be the beneficial owner of the dividends. Any person resident in a Contracting State to whom that State attributes the dividend for purposes of its tax is the beneficial owner. (*see* paragraph 140 of the Technical Explanation US Model) The OECD Commentary on Article 10, para 12.1 provides that it is inconsistent with the object and purpose of the Convention (avoiding double taxation and prevention of fiscal evasion and avoidance) for the State source to grant relief and exemption—

- merely on account of the status of the immediate recipient as resident of the other Contracting State as no double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence ;
- where a resident simply acts as a conduit for another person who in fact receives the benefit of the income concerned

In both the cases, the recipient is not the owner of the income. Only the beneficial owner resident is entitled to the benefit. The interposition of an intermediary such as an agent or nominee (located in a Contracting State or in a third country) between the payer and the beneficiary may not disentitle the beneficial owner of the benefit who is resident of the other Contracting State (*see* OECD Commentary, article 10, paragraph 12.2)

Dividend withholding tax - Beneficial ownership, meaning

16.4-1 The reduced of tax in terms of paragraph 2 is applicable if the recipient besides being a person and resident of the contracting state is the beneficial owner of the dividends. Ownership denotes a relation between a person and any right that is vested in him. A property may vest in title or may vest in possession or it may vest in a limited sense, as indicated in the context. The concept of beneficial ownership involves a fiduciary relationship or equitable obligations. That relationship exists where one person has legal title and/or control over the property or other advantage, while beneficial ownership resides in another. It is an obligation annexed to the ownership of a property for the benefit of another. The property is held in trust. The legal ownership which is vested in the trustees is separated from beneficial ownership *i.e.*, the right to the enjoyment and use. The said obligation may be legal, statutory, contractual or customary. The terms "beneficiary" or the "beneficial owner" are used to designate a person who benefits financially from the property held by another. The definition of beneficial ownership is contained in paragraph 14 of the OECD report on Double Taxation Convention and the Use of Conduit Companies (The report has been concluded in the OECD, International Tax Avoidance and Evasion, Four Related Studies, Paris, 1987), "A conduit company can normally not be regarded as beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of interested parties".

Beneficial ownership is a concept which generally requires that it must lay with the investor as a matter of law, whether it is through a trust or it is a joint ownership. But beneficial ownership has a specific meaning in the context of a treaty. Legal form is not so relevant as the substance. Incorporation may help. But it does not guarantee treaty access.

Thus, the "beneficial owner" of a dividend is understood generally to refer to any person resident in Contracting State to whom the State attributes the dividend for tax purposes. Persons receiving dividend nominally but not controlling the recipient company are not the beneficial owner.

For treaty purposes, the term "beneficial owner" is not to be interpreted in a narrow technical sense, rather, it should be understood in its context and in the light of the object and purposes of the treaty, including avoiding double taxation and the prevention of fiscal evasion and avoidance (*see* OECD Commentary, article, paragraph 12) It is an anti-avoidance measure under a treaty to prevent treaty shopping.

The benefit of the Article is limited to the beneficial owner. The extension to persons other than the beneficial owner would have been inconsistent with the object and purpose of the treaty because—

- the immediate recipient of the income qualifies as a resident but no potential double taxation arises as a consequence of that status, since the recipient is not treated as the owner of the income for tax purposes in the state of residence.
- the resident of the contracting state, as an agent or nominee, acts as a conduit for another person who in fact receives the benefit of the income concerned.

A conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties (*see* OECD Commentary, paragraphs 12 to 12.2).

Dividend withholding tax, beneficial ownership - Purpose

16.4-2 The treaty benefits of reduced rates of withholding tax with regard to dividends, interest and royalties are intended to go to the real owners rather than to the formal title holders. The substance of the ownership rather than the form is important. The reason for limiting the benefit to the real rather than the formal owner is to help preventing evasion of tax and also preventing treaty shopping. The purpose of the restriction according to the commentary to the 1992 OECD model convention is not to be available where an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer unless the beneficial owner is the resident of the other contracting state. It is also intended to deal with treaty-shopping where a person acts through a legal entity created in a state essentially to obtain treaty benefits that would not be available directly to such person. Thus the requirement of beneficial ownership excludes the nominee or the agent and prevents treaty shopping. Next to the requirements of a company being a "person" and a "resident", articles 10, 11 and 12 demand that the company is the beneficial owner of the dividends or the interest or the royalties, to be able to obtain the reduced rate of withholding tax. The requirement of beneficial ownership is not insisted upon with respect to article 6 or 13. For them to be applicable, what is necessary is that the enterprise is a person and resident of the contracting state.

The question of beneficial ownership is linked to the broader issue of how to qualify a foreign entity for tax treaty purposes, as a separate taxable unit or fiscally transparent. The general theory underlying the provisions is that treaty benefits an income recipient only if the recipient has a sufficient nexus with the other contracting state. The Authority for the Advance Ruling (*AAR No. P-10 of 1996, In re*) held that,

"The rate of five per cent will be available only where the recipient of the dividends is the beneficial owner of the dividends and that, too, when it holds directly at least 10 per cent of the capital of the company paying dividend. In the present case, the Indian companies pay dividends to the CT as trustee and not as beneficial owner. It may seem that the logic of treating the investor company as the direct recipient of the dividends by reason of the application of section 161 (of the Indian Income-tax Act, 1961) should be extended here also but such a view would run counter to the explicit language used in article 10(2)(a) of the treaty (India/Mauritius) and also to its manifest intent that no concessional treatment will be available if the person holding the shares in the company is not its beneficial owner. In any event, even if such interpretation be acceptable, the relief asked for can be available only if the holding of the Mauritian (through the CT) exceeds 10 per cent of the share capital of the company paying dividend. The dividends, therefore, will be taxable at the rate of 15 per cent".

Dividend withholding tax, beneficial ownership - Advance ruling with respect to Indian - Mauritian tax treaty

16.4-3 As already discussed, treaty benefit could be denied where the relationship between the corporation paying dividends and the corporation receiving them has been arranged or maintained primarily with the intention of securing reduced rate of withholding tax. The Authority for the Advance Ruling applied this principle in its decision of the 22nd December, 1995 (*AAR No. P-9 of 1995, In re*). In that case two companies incorporated in Mauritius which held shares in an Indian bank applied for a ruling on the question whether the tax payable by them on the dividends they might receive in respect of their shares in the Indian bank would be only 5 per cent in terms of paragraphs 1 and 2 of article 10 of the tax treaty between India and Mauritius. The companies had disclosed that their own equity capital was held wholly by a British bank which was the real and the beneficial owner of their assets, including the shares in the Indian company. It was noted that that if the British bank had directly invested in shares in the Indian bank it would have been entitled to the relief provided by the tax treaty of 1993 between India and the United Kingdom, and that under article 11(3) of that treaty, dividend paid to resident of England by an Indian company would be charged to Indian Income-tax at 15 per cent. The Authority was of the opinion that for the purpose of investment in the Indian bank through the two applicant companies set up in Mauritius could only be the avoidance of income-tax. The Authority observed as follows :—

"Under this article (article 10), the dividends derived by the resident of Mauritius from a company resident in India will be taxable at the rate of 15 per cent on their gross amount. However, a concessional rate of five per cent is stipulated where the two conditions set out in sub-paragraph (a) of paragraph 2 of this article are satisfied. That concessional rate will be applicable if the recipient of the dividend (i) is the beneficial owner of the shares in question and (ii) holds directly at least ten per cent of the capital of the company paying dividend. The second of these conditions is clearly satisfied. The question, however, is whether the first condition is also satisfied. On behalf of the applicant it was argued that the applicant companies are the direct

shareholders in the Indian bank, that neither they nor any other persons have given notice of any beneficial interest in the shares under section 187C of the Companies Act, 1956, and that therefore, they should be treated also as the beneficial owners of the shares. It is true that no notice has been given by the applicant - companies or by the British bank of any beneficial interest in the shares in any person other than the nominal owners of the shares, namely, the applicant-companies. The Indian Companies Act, 1956, however, does not forbid share holding through nominees. On the other hand, section 49(3) - referred earlier - envisages it in certain situations and section 187C only requires declarations to be filed by the real holder and the nominee of the holder on pain of certain penalties. Non-filing of such declarations cannot, however, be conclusive of the nature of the holding. It is true that under the company law, a corporation, is an independent entity and cannot be said to be holding its assets or profits in trust for the share holders. However, in view of the categorical admission that all the shares of the applicant-companies are held by the British bank and consequently, the entire funds of the applicant-company by way of share capital have been contributed by the bank, the inevitable inference is that it is the British bank and not the applicants which is the real and the beneficial owner of the assets of the applicant-companies including shares in the Indian bank. The shares as well as the income arising therefrom are held by the applicant only subject to control and direction of the sole shareholder which can deal with these assets or the income therefrom in whatever manner it likes by virtue of its sole share holding in the applicant-companies. It is, therefore, possible to take the view that the applicant-companies are not the beneficial owners of the dividends payable on the shares in the Indian bank and that, therefore, the dividends received by them from the Indian bank are liable to be taxed at 15 per cent of the gross amount thereof and not at five per cent as claimed".

In paragraph 19 of the ruling, the Authority observed :—

"It will be seen that though the purpose of the restriction is said to prevent tax avoidance by persons not entitled to protection by a particular treaty claiming the same with the help of interposed persons, it has been opined that the mere fact that the shares are held by a 100 per cent subsidiary does not preclude necessarily its beneficial ownership in the assets held by it in the absence of other factual indications pointing out the existence of the beneficial ownership in the holding company. A similar view can also be seen in Gore-Brown on Companies Vol. 1, para 1.3.1, where it said :

‘in some cases the courts have found on the particular evidence before them that a holding company was in fact carrying on business through the agency of its subsidiary company. It is important to note that the mere fact the one company is the subsidiary of another, even a ‘wholly owned’ subsidiary, is not by itself sufficient to make the subsidiary an agent of its holding company. The activities of the subsidiary must be so closely controlled and directed by the parent company that the latter can be regarded as merely an agent conducting the parent company’s business’."

Dividend withholding tax, beneficial ownership - Shareholders residents of third country

16.4-4 The question of beneficial ownership may be linked to the broader issue that the benefit of the treaty is available to the residents of the contracting states. The corporate status may be abused by the residents of the third states to obtain in the source state treaty benefits which they themselves would not be entitled to in case of direct investment. The requirement of beneficial ownership is a restriction intended to deal with treaty - shopping where a person acts through legal entity to obtain treaty benefits that would not be otherwise available. For that purpose a "pass-through" nature of an entity is applied. Para 22 of the OECD Commentary, article 10, drew attention to the following case:

"The beneficial owner of dividends arising in a Contracting State is a company resident of the other Contracting State ; all or part of its capital is held by shareholders resident outside that other State ; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the state of source of the dividends the limitation of tax which is provided in paragraph 2.

The Commentary suggested "It may be appropriate when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in the article, in order to define the treatment applicable to such companies."

If the doctrine of "look through" is applied, especially in cases where such a company has been established to obtain the benefit of a treaty, would not qualify for the benefit, as the ultimate recipients of the income are not the residents of the Contracting State but of a third State, the company is acting only as a conduit.

The treaty benefit may be denied unless more than agreed per cent of its shares are owned by the residents to the contracting states. A foreign controlled corporation (CFC) under the US laws means a foreign corporation more than fifty per cent of the stock of which (by vote or value) is owned directly or indirectly by the US shareholders and US shareholder for this purpose is a US person who owns, directly or indirectly, 10 per cent or more of the CFC Stock (by vote). The general theory underlying such a provision is that one state accord treaty benefits to an income recipient only if the recipient has a sufficient nexus with the other state. Treaty benefit has been denied, as already discussed, where the relationship between the corporation paying the dividend and the corporation receiving had been arranged and maintained primarily with the intention of securing reduced rate. Such determination is, however, subjective. To make determination more transparent, article 16 of the 1977 US model provides,

"If 25 per cent or more capital of a company which is resident of a Contracting State is owned directly or indirectly by individuals who are not resident of that State and if by reason of special measures the tax imposed by that state on the company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned state on corporate business profits, then notwithstanding the provisions of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties".

The 1981 US model treaty contains a new formula for limiting benefits. All United States treaties ratified since 1981 contain a "limitation of benefits" provisions. This generally limited the right to treaty withholding rates to the host-country entities that were at least 50 per cent by the host country residents or United State residents. Persons resident in a contracting state if (i) more than fifty per cent of the beneficial ownership interests in the persons are owned by US citizens or by qualified residents and (ii) less than fifty per cent of the person's gross income is paid out to non-residents in the form of interest and royalties or other deductible payments, are eligible for benefit.

The US treaty with India provides a reduced withholding tax rate on dividends paid from one contracting state to a resident of the other contracting state. It provides a further rate reduction if the recipient of the dividend satisfies a minimum ownership threshold of ten per cent of the stock of the company paying dividends. However, further reduced rate will not apply in case dividends are paid by the

- ♦-United States regulated investment company (RIC);
- ♦-United State person which is a Real Estate Investment Trust; and,
- ♦-if the dividend is beneficially owned by an individual holding less than 10 per cent interest in the Real Estate Investment Trust.

An RIC is a US corporation classified as such if 90 per cent of its gross income for its taxable year is derived from certain passive investment type sources. Permissible sources are dividends, interest, payments with respect to security loans, gains from the sale or the other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investing in stock, securities or foreign currencies. It must distribute each year at least 90 per cent of its investment company taxable income (ICTI) and at least 90 per cent of its net tax-exempt income. The ICTI includes dividends, interest and net short-term capital gains in excess of net long-term capital losses. Also, either the RIC must have taxable income as a RIC of all of its prior taxable years, or it must have no accumulated earnings and profits from taxable years when it was not taxable as an RIC.

Dividends withholding tax-beneficial ownership-holding of ten per cent of "capital" Dividends withholding tax-beneficial ownership-holding of ten per cent of capital

16.4-5 Beneficial ownership holding directly 10 per cent of the capital of the company paying dividend is the requirement to receive the benefit of reduced rate. The term "capital" is used in relation to the tax treatment of dividends, *i.e.* , distribution of profits to shareholders; in the sense in which it is used for the purposes of distribution to the shareholders. Therefore, "No account need be taken of differences due to the different classes of shares issued (ordinary shares, preference shares, plural voting shares, non-voting shares, bearer shares, registered shares, etc.) as such differences relate to more to the nature of shareholder's right than to the extent of his ownership of the capital [*see* paragraph 15(c) of the OECD Commentary on Article 10]. The loan, though strictly not considered "capital" under the Company Law is so treated for the treaty purposes if according to the domestic

law income derived in respect thereof is treated as dividends (e.g, thin capitalisation, or assimilation of a loan to share capital).

The convention does not require that the ten per cent of the capital be held for a minimum period prior to the dividend payment date. The holding has to be seen at the time of payment. However, where there is abuse of the provision, the benefit may be denied. Paragraph 17 of the OECD Model on Article 10 states:

"The reduction envisaged in sub-paragraph (a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction..."

Dividends - Mode of taxation

16.4-6 The article does not provide the mode of taxation. It may be done as per the domestic law. Tax may be levied by deduction of tax at source or by individual assessment (*see* OECD Commentary, article 10, paragraph 18)

Dividends - Defined

16.5 Paragraph 3 of article 10 defines dividends as to mean income from shares ("jouissance" shares or "jouissance" rights, mining shares, founders' shares) or other rights. It is an appropriation of profits to shareholders. Debts-claims participating in profits are not shares. Interest on such-debt claims is, therefore, not dividend. It also means income from other corporate rights which is subjected to the same taxation treatment as income from shares by laws of the state of which the company making the distribution is a resident.

The definition consists of two parts—

- income from shares
- 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 first part refers to income from rights participating in the profits of a company. That right is constituted by shares. "Share" is a concept well understood under the companies laws. The notion of dividends basically concerns with distribution of profits to the shareholders by companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies (*see* OECD Commentary, article 10, paragraph 1). The definition relates to distribution of profits the title to which are constituted by shares that is holding in a company. Dividends are the income from the capital which the shareholder have made available to the company as its shareholders. The definition covers all securities issued by companies which carry the right to participate in the profits without being the debt claims, such as 'jouissance' shares or 'jouissance' rights, mining shares, founders' shares or other rights. IBFD International Tax Glossary defines 'jouissance' rights as "right to participate in a corporation's office without being a debt claim" and 'jouissance' share as "securities issued by companies in some countries which carry any right to the capital surplus (if any) upon liquidation of a company and may also entitle their holders to a percentage of annual profits 'jouissance' shares may be issued on the occasion of a company reorganization where part of the capital is amortized and the rights of the current shareholders are reduced. In such a case, to a certain extent, they represent compensation for the loss suffered by the shareholders." Roy Rohtagi Basic International Taxation, "Glossary" defines 'jouissance' share to mean that gives the shareholders a right to the capital surplus (if any) upon liquidation of accompany and entitle them to a share of the annual profits. The shares represent compensation for the loss suffered by the shareholders when a company is reorganized and the rights of a current shareholders are reduced.

The notion of dividends basically concerns distribution by companies of their profits. The definition, therefore, relates to distribution of profits the title to which are constituted by shares, that is holdings in a company limited by shares. The definition assimilates to shares all securities issued by the companies which carry right to participate in the companies' profits without being debt-claims. A share is a chose-in-action. A chose-in-action implies the existence of some persons entitled to the rights, which are rights in action as distinct from right in possession - *V.G.M. Holdings Ltd. In re* [1942] 12 Comp. Cas. 254 (CA) and *CIT v. Master Raghuveer Trust* [1985] [151 ITR 368](#) (Kar.). A share itself is an object of dominion, i.e., of right *in rem* and not so to regard it would be barren and academic in the extreme - *Gower's Modern Company Law*, 3rd edn., p. 344. A shareholder has rights to receive dividends, to attend meeting and vote, right to participate in the assets of the company on its winding and liquidation - *Anarkali Sarabhai v. CIT* [1982] [138 ITR 437](#) (Guj.).

The term 'dividends' means the distribution of profits to the shareholders limited by shares. It represents the stockholder's share of that part of the profit of the business which the Board of Directors decides to distribute. The ordinary meaning of the term 'dividend' is share of profits, whether at a fixed rate, otherwise allocated to the holder of shares in a company. The term is generally used with reference to the trading and other companies and to the payments made to the members of a company as such and not by way of remuneration for services. It may also refer to such shares of profits as are divided only occasionally and are usually called 'bonuses' or 'bonus dividends' - *Halsbury's Laws of England*, 3rd edn., Vol. 6, 396.

Paragraph 3 defines the term "dividends" broadly and flexibly which is intended to cover all arrangements that yield a return on equity investment as determined under the tax laws of the State of source, as well as arrangements that might be developed in the future. Participation in the distribution by a company of its profits is the basic requirement, whatever nomenclature is assigned.

Thus, a person must have a right of

- participation in
- the distribution of profits

Participation - participation debt - claim not covered

Participation means taking the hazards of enterprise. All participants in the distribution of profits share the risks run by the company. What distinguishes a pure investment to earn interest from an investment in an undertaking with a right to participate in its profits is that no risks are involved in such investment; the income by way of interest assured irrespective of whether or not the company makes a profit. But in equity investment there is always risk of its likely loss, if the venture does not succeed. Compensation in case of a debt may be on agreed fixed rate or linked to profitability. Such participation debt in the profit does not change the nature of debt-claim and the compensation does not represent dividends because by such participation the lender does not undertake any entrepreneurial risk. While defining "debt capital", IBFD International Tax Glossary pointed out distinction between debt capital and equity capital thus:

"One method of financing a business is by funding through debt capital, *i.e.*, funds obtained through various types of loan. Debt capital normally comprehends debentures and bonds bearing fixed interest. There are, however, hybrid forms of capital, such as bonds which are convertible into shares (*i.e.*, a convertible bond), bonds bearing interest at rates which depend on the profitability of the company (participating bonds), etc.

As a general rule interest paid on borrowed funds is a deductible expense, whereas dividends from profit distributions to shareholders are not deductible. In certain circumstances what is ostensibly debt capital is recharacterized as equity capital and therefore subject to rules of taxation of dividends"

The OECD Commentary in paragraph 24, therefore, explains "debt claims participating in profits do not come into this category likewise interest on convertible debentures is not a dividend".

But, however, if the lender effectively shares the risks run by the company, *i.e.*, when repayment depends largely on the success or otherwise of the entrepreneur business, such interest bears the nature of dividends (*see* OECD commentary article 10, paragraph 25). The commentary provides circumstances under which such a participation with risks could be inferred and interest taken as dividends, as follows:

- the loan very heavily outweighs any other contribution to the enterprise's capital (or was taken out to replace a substantial proportion of capital which has been lost) and is substantially unmatched by redeemable assets;
- the creditor will share in any profits of the company;
- repayment of the loan is subordinated to claims of other creditors or to the payment of dividends;
- the level of repayment of interest would depend on the profits of the company;
- the loan contract contains no fixed provisions for repayment by a definite date.

Payments denominated as interest that is made by a thinly capitalized corporation may be treated as dividend to the extent the debt is recharacterised as equity under the laws of the source State (discussed in paragraph 16.5-4)

Distribution of profits

By "dividends", as aforesaid, is generally meant distribution of profits to the shareholders by companies limited by shares, limited partnership with share capital, limited liability companies or other joint stock companies. Distribution by co-operative societies are also regarded as dividends (*see* OECD Commentary, paragraph 26), but

not done by partnership if not treated as a company (OECD Commentary, paragraph 27). The word "distribution" in a narrow sense means distribution of profits decided by annual general meetings of the shareholders. In a wider sense, it is generally used to refer to any distribution of corporate assets to shareholders for no adequate consideration (*see* IBFD International Tax Glossary). Thus, other benefits in money or money's worth, such as bonus shares, bonuses, profits on a liquidation and disguised distribution of profits, irrespective of whether they are paid out of current profits or from reserves are also dividends (*see* OECD Commentary, article 10, paragraph 28) as also in the hands of other persons than shareholders whose holding in the company is a concealed holding and who are closely connected with a shareholder (*see* OECD Commentary, article 10, paragraph 29). Distribution of capital does not constitute dividend (OECD Commentary, paragraph 28).

The term "dividend" also includes income that is subjected to the same treatment as income from shares by the law of the State of source.

Dividends - Indian Income-tax Act

16.5A The Indian Income-tax Act does not contain any exhaustive or restrictive definition of dividend, it contains only an inclusive definition.

Any dividend declared by a company or distributed or paid by it within the meaning of sub-clause (a), (b), (c), (d) or (e) of clause (22) of section 2 of the Indian Income-tax Act, 1961 is deemed to be the income of the previous year in which it is so declared, distributed or paid, as the case may be [section 8(a) of the Act]. Three contingencies relating to the inclusion of dividend income in the total income are postulated :

- ◆ Declaration by the company
- ◆ Distribution by the company
- ◆ Payment by the company

The last two contingencies would arise in regard to deemed dividend under the provisions of section 2(22)(a), (b), (c), (d) and (e). The expression 'dividend' as defined in section 2(22) extends its scope. Apart from declaration, distribution or some payment is contemplated to mean dividend. Only such 'payment' as contemplated in section 2(22)(e) and not any other is taken to mean dividend and the expression 'paid' in section 8 has to be read in the context of such payment; it refers to it (the payment). Otherwise, the right of a shareholder accrues on the declaration of dividend by the company.

Dividend - Declaration

16.5A-1 The scheme of the Income-tax Act postulates attraction of tax at the first stage of accrual, which in the case of dividend takes place on the declaration by the company. Section 8 of the Act supports the postulate, when it provides, by fiction of law, that income from dividend is the income of the previous year in which it is declared by the company - *CIT v. Godfrey Philips India Ltd.* [1986] [161 ITR 684](#) (Bom.). However, the interim dividend declared by a resolution of the Board of Directors of a company is not dividend 'declared...by the company' - *CIT v. Godfrey Philips India Ltd.* [1986] [161 ITR 684](#) (Bom.). The power to pay an interim dividend is usually vested by the articles of association in the directors. For paying interim dividend, a resolution of the company is not required; the directors are authorised by the articles of association to pay the said amount which they think proper having regard to their estimate of profits made by the company. On payment, the interim dividend becomes the property of the shareholders, but a mere resolution of the directors involving to pay a certain amount as interim dividend does not create a debt enforceable against the company for, it is always open to the directors to rescind the resolution before the payment of the interim dividend. Thus the nature of interim dividend is quite different from the dividend, which upon declaration by a company in its general meeting gives rise to debt - *J. Dalmia v. CIT* [1964] [53 ITR 83](#) (SC). This rule applies only in the case of dividends declared by the company in a general meeting.

Dividend - Distribution

16.5A-2 Besides declaration of dividend, certain mode of payment or advance is taken as distribution or payment of dividend. Dividend may be distributed by delivery of a property or a right having a monetary value - *Kantilal Manilal v. CIT* [1961] [41 ITR 275](#) (SC).

Dividend - Payment

16.5A-3 The word 'payment' is given a wider meaning and should not be confined to the actual payment, but be extended to where the amount is unconditionally made available to another person - *Benares State Bank Ltd. v. CIT* [1970] [75 ITR 167](#) (SC). In general the dividend could be said to be paid when the company has discharged its liability and made the amount of dividend unconditionally available to the shareholder - *J. Dalmia v. CIT* [1964] [53 ITR 83](#) (SC).

Dividends definition - Thin capitalisation

16.5A-4 As discussed, dividends represent appropriation of profits. Sometimes appropriation is done under a guise, through a device known as "Thin capitalisation" (the concept has been discussed before). The corporation is not financed by the requisite equity. It is done by providing loan. There is an abnormal proportion of debt to equity. It is done because interest is normally a deduction in calculating taxable profits. Dividends are not so deductible. In that case the tax authorities would be justified to treat the amount of interest as dividends. The Commentary on the OECD model emphasises that neither article 10 or article 11 prevents the operation of the national rules about the capitalisation which treat interest on loans as dividends where the contributor of the loan effectively shares the risks run by the company, *i.e.*, where the payment depends largely on the success or otherwise of the company's business. In such a situation, the doctrine of debt - claim will not be applicable.

Dividends definition - Units of Mutual Trust

16.5A-5 A Unit Trust of India has been declared by section 32(3) of the Unit Trust of India Act, 1963, to be company for the purposes of the Indian Income-tax Act, 1961, and income distributions by it treated as "dividends" for the purposes of its certain provisions such as section 80L (*vide* CBDT Circular No. 567, dated the 19th July, 1990, [1990] 184 ITR (St.) 164). The Act refers to income from units separately from "dividends" at several places and it is also not certain that the "units" can be said to be shares within the meaning of the above definition. They are, however, other rights participating in the profits and fall within the definition if the income from them is accorded the same tax treatment by the Act as dividend income from shares. On this aspect it is found that the Act accords the same tax treatment to income from units of the Unit Trust of India (UTI) and from mutual funds covered by section 10(23D) of the Act (*see* sections 80CC, 80L, 88A, 115A). Section 115AB and section 115AC of the Act provide for analogous concessions in respect of units and dividends respectively. Section 80M (since deleted) seemed to be exception. The income from units of the UTI and mutual funds specified in section 10(23D) are treated as dividend income falling under article 10 of the treaty [*see* Advance Ruling in the case of *Dr. Rajnikant R. Bhatt v. CIT* AAR No. 268 of 1996 1st August, 1996 and also Advance Ruling in *DLJMB Mauritius Investment Co. v. CIT* (AAR No. 315 of 1997 decided on the 16th July, 1997)].

Dividend - Deemed - Section 2(22) gives an artificial definition of dividend. The dividend taken note by that provision is a deemed dividend and not a real dividend. The loan granted to a shareholder or advance given to him in the circumstances mentioned therein, has to be returned or accounted for. It does not become the income of the shareholder. For certain purposes, the Legislature has deemed such loan or advance as dividend - *CIT v. C.P. Sarathy Mudaliar* [1972] [83 ITR 170](#) (SC). Under section 2(22), the following payments or distribution by a company to its shareholders are deemed dividend to the extent of the accumulated profits:

- ◆ Any distribution of accumulated profits entailing the release of company's assets
- ◆ Any distribution of debentures, debenture stock, deposit certificates and bonus to preference shareholders
- ◆ Distribution on liquidation of company
- ◆ Distribution on reduction of capital
- ◆ Any payment by way of loan or advance by a closely-held company, to a shareholder holding substantial interest provided the loan should not have been made in the ordinary course of business, or payment by any such company on behalf of or for the individual benefit of any such shareholders.

The Finance Act, 1987 has, however, provided that any payment made after 31-5-1987 by way of advance or loan to the following shall be treated as dividend :

- ◆ A shareholder (being a person who is a beneficial owner of equity shares) holding not less than 10 per cent of voting rights
- ◆ Any 'Concern' means Hindu undivided family or a firm or an association of persons or body of individuals or a company; and 'substantial interest', in a concern other than the company, means such person is entitled to not

less than 20 per cent of the income of such person in which such shareholder is a member or a partner in which he has substantial interest.

Distribution of accumulated profits through release of assets or property or payment of loan or advances is deemed dividend. The expressions 'distribution', 'payment', 'accumulated profits', 'loan' and 'advances' require examination.

Distribution - The dictionary meaning of the expression 'distribution' is to give each a share; to give to several persons. The expression 'distribution' connotes something actual and not notional. It can be physical; it can also be constructive. One may distribute amounts between different shareholders either for crediting the amount due to each in his account or by actually paying to him the due amount. It is culmination of a process - *Punjab Distilling Industries Ltd. v. CIT* [1965] [57 ITR 1](#) (SC) and *CIT v. Jasrup Baijnath & Sons (P.) Ltd.* [1971] [82 ITR 513](#) (Cal.). It means any payment to owners of shares, including any of the various forms of dividend - *Eric L. Kohler : A Dictionary for Accountants*, 5th edn.

Accumulated profits - Accumulation implies some gradual accretion, a heaping of matter increasing from day-to-day. Accumulated profits mean income retained and not paid out in dividends or dissipated by subsequent losses - *CIT v. M.V. Murugappan* [1970] [77 ITR 818](#) (SC). Only when are there profits accumulated over a number of years, can there be possibility of payment in the circumstances mentioned in sub-clauses (a) to (e) of clause (22) of section 2. The accumulated profits cannot include current profits - *CIT v. M.V. Murugappan* [1970] [77 ITR 818](#) (SC). These mean profits in the commercial sense and not assessable or taxable profits liable to tax as income - *P. K. Badiani v. CIT* [1976] [105 ITR 642](#) (SC). The accumulated profits could be in any of the following form :

- ◆ General reserves, unless the profits so transferred to reserves are capitalised in one form or other - *CIT v. K. Srinivasan* [1963] [50 ITR 788](#) (Mad.).
- ◆ Specific reserves, the fact that the amounts standing to the credit of the reserves can be used only under certain circumstances and subject to certain conditions cannot change the character of the amounts as profits as also forming part of the accumulated profits - *T.M. Rangachari v. CIT* [1976] [102 ITR 50](#) (Mad.).
- ◆ Building reserves - *CIT v. Jaldu Rama Rao* [1983] [140 ITR 168](#) (AP).
- ◆ Development rebate reserve/investment allowance - *P. K. Badiani v. CIT* [1976] [105 ITR 642](#) (SC).
- ◆ Tax-free profits, e.g., agricultural income - *Tea Estate India (P.) Ltd. v. CIT* [1976] [103 ITR 785](#) (SC).
- ◆ Initial depreciation - *P. K. Badiani v. CIT* [1976] [105 ITR 642](#) (SC).

The following are not taken as accumulated profits :

- ◆ Provision for taxation - *CIT v. V. Damodaran* [1972] [85 ITR 590](#) (Ker.).
- ◆ Provision for dividend - *P. K. Badiani v. CIT* [1976] [105 ITR 642](#) (SC).
- ◆ Normal depreciation - *P. K. Badiani v. CIT* [1976] [105 ITR 642](#) (SC).
- ◆ Balancing charge under section 41(2) - *CIT v. T. S. Rajam* [1980] [125 ITR 207](#) (Mad.) and *CIT v. Urmila Ramesh* [1998] [230 ITR 422](#) (SC).
- ◆ Expenditure disallowed in the assessment - *Rajpal Bros. (P.) Ltd. v. CIT* [1971] [80 ITR 463](#) (Bom.).
- ◆ Capital gains not chargeable to tax - *CIT v. Mangesh J. Sanzgiri* [1979] [119 ITR 962](#) (Bom.).

Loans and advances to registered shareholders - Loan or advance allowed to a shareholder is dividend. The shareholder should be a registered shareholder. When, suppose an advance or loan is given to a Hindu undivided family, whose karta is the registered shareholder of the advancing or lending company, the amount thus advanced or loaned cannot be taken deemed dividend, because the karta is the registered owner, though the beneficial ownership vests with the Hindu undivided family and it is not the registered owner who is getting advance or loan - *Rameshwarlal Sanwarmal v. CIT* [1980] [122 ITR 1](#) (SC) and *R.B. Seth Ram Rattan v. CIT* [1985] [156 ITR 612](#) (Delhi). The Finance Act, 1987, however, amended the section by virtue of which advance or loan to such person as Hindu undivided family is deemed dividend.

Loan and advance - Payment of loan is taken as dividend irrespective of the fact that such loan is temporary for a few days - *Walchand & Co. Ltd. v. CIT* [1975] [100 ITR 598](#) (Bom.). The fiction comes into operation at the time of payment of advance or loan to shareholder. The tax is attracted to the amount thus paid to the extent of accumulated profits. Even if the loan or advance is subsequently repaid or adjusted so that no amount is

outstanding at the end of the year, it would still be assessed as deemed dividend—*Smt. Tarulata Shyam v. CIT* [1977] [108 ITR 345](#) (SC).

In *Dictionary for Accountants*, 'advance' has been defined as payment of cash or the transfer of goods for which accounting must be rendered by the recipient at some later date. By Eric L. Kohler, A dictionary for Accountants, 5th edn. Section 2(22)(e) makes it clear that any payment by any company of any sum representing a part of the assets by way of advance would come within the mischief of the said section. The Calcutta High Court in *M.D. Jindal v. CIT* [1987] [164 ITR 28](#) held that value of the goods supplied by the company to the assessee and his wife could be treated as dividend.

Dividends - Taxed as income from business or profession

16.6 Article 10 deals only with dividends paid by a company which is resident of a Contracting State to a resident of other Contracting State (*see* paragraph 1 of the Article). Third country residents are not covered. Similarly, permanent establishment in the Source State which carries on business in that State is not covered. It is a branch of non-resident and dividend attributable to it cannot be said to have been paid for the purposes of Article 10, to the resident of the other Contracting State.

Paragraph 4 spells out circumstances which exclude the applicability of paragraphs 1 and 2 in relation to dividend income. Exclusion means the removal of limitation on the State of source of the dividends which this article prescribes, and does not mean prevention of the source State from taxing the dividends or exclusion of its jurisdiction or as also of the jurisdiction of residence State.

Paragraph 31 of the OECD Commentary, article 10, provides:

"... It does not stipulate that dividends flowing to a resident of a Contracting State from a source situated in the other State must, by kind of 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 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 owed by the beneficiary which is a resident of the other State, if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 4 relieves the State of source of the dividends from any limitation under the Article. The foregoing explanations accord with those in the Commentary on Article 7."

Paragraph 4, thus, excludes from source country limitation under paragraph 2 dividends paid with respect to holdings that form part of the business property of a permanent establishment. Such dividends are taxable on a net basis using the rates and rules of taxation generally applicable to residents of the State of source (*see* Technical Explanation, US Model Convention). The Technical Explanation illustrated by an example, dividends paid with respect to the business property of permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers.

Dividends - "Effectively connected" with permanent establishment or fixed base

16.6-1 The applicability of paragraph 4 of Article 10 is conditioned by the fact that holding in respect of which dividends are paid is effectively connected with the permanent establishment or the fixed base. For income to be attributable to PE, the PE must be a material factor in the production of such income. The threshold material factor under the doctrine of "force of attraction" is the engagement in trade or business in source state. If that factor is met all business income is taxed, even that income derived from a different business other than the business that was conducted in that state. The same result holds for other income if it is of a type that is taxable and the requisite connection exists between such income and the PE. In either case, the non-resident Company is taxed on the net amount of effectively connected income.

If income is not effectively connected with that business, there is no force of attraction rule to tax it. Paragraph 4, therefore, is not based to the force of attraction rule of the PE.

Thus, dividends are taxable in the Source State as part of the profits of the permanent establishment, if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively

connected with that establishment. The State of source of the dividends is relieved from any limitations under Article 10. The requirement of "effectively connected" with the PE, the shareholding should be genuinely connected to the business of PE carried on through a particular location (*see* OECD Commentary, paragraph 32). Income is effectively connected if the non-resident has an office or other fixed place of business in the source country, and the income is attributable to that office or fixed place. It is so attributable if the office or the fixed place, is a "material factor" in the production of income, regularly carries on the activities of the type from which the income is derived; and income attributable is "properly allocable" to that office or fixed place.

If a non-resident has trade or business in the source state all of its inventory sales income in that state will be considered to be effectively connected income subject to tax, whether or not sales are actually related to the trade or business in that state. Inventory sales are generally sourced to where title to the goods are passed. Thus, there are certain shareholdings or indebtedness which are effectively connected with the PE. Dividends or interest, in that case, is taxable as business income attributable to the PE similar is the case as regards royalty income.

The concept of "effectively connected" applies to the following kinds of income :

- (a) rents or royalties for the use of intangible property ;
- (b) dividends or interests;

Royalties or interest are effectively connected with the PE, if they are in incremental proceeds considered in the light of the permanent establishments primary business activities. They would not be so taken if they are attributed more or less accidentally to the permanent establishment.

Dividends - Non-taxability if paid by non-resident parent company

16.7 Article 10 deals only with dividends paid by a company which is a resident of a contracting state to a resident of the other state. The term "dividends" has been defined in paragraph 3 as to mean income from shares participating in profits. It is an appropriation by a resident company of profits to shareholders. Distribution of profits by a non-resident companies is not dividend. But some states impose tax on such distribution also. Each state is entitled to tax profits arising in its territory to such non-resident companies if they have permanent establishment and as provided in article 7. Taxing income as profits from business in terms of article 7 and also taxing it on its distribution would amount to double taxation. The shareholders who are not residents of the state should not be taxed on the amount received by way of distribution. Paragraph 5, therefore, rules out the practice by which states tax dividends distributed by the non-resident companies only because the corporate profits from which the distributions are made originated in their territory. It therefore, deals with a situation where a company resident in one contracting state derives profits or income from the other contracting state and pays dividends. The State may not impose a "secondary withholding tax" on dividends paid by a non-resident company out of the earnings and property from that state. Thus the state may not impose any tax on such dividends, save in exceptional circumstances. The circumstances are :—

- ◆ The dividends are paid to a resident of the other state, or
- ◆ The shareholding is effectively connected with permanent establishment or the fixed base situated in that other state.

The other state may not subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist of wholly or partly of profits or incomes arising in such other state.

Thus paragraph 5 is another exception to paragraphs 1 and 2, in relation to dividends paid by a company which is resident of a contracting state to a resident of other contracting state if the paying company derives profits and income from the other contracting state, save under the circumstances mentioned above. In fact the article deals with the payment of dividends by the company which is the resident of one state to the person resident of the other, not when the company and the recipient both belong to the same state. The origin of a profit in one contracting state is not a relevant consideration for the state to assert its right to tax under article 10, when neither the company declaring the dividends out of such profit, nor the recipient is resident of that state. A state may have a right to tax profits arising in its territory which are made by non-resident companies. Article 7 so authorises. But when it comes to taxing of dividends, the position is different. It is an established law that in case of a company, a company itself is chargeable to tax on its profits and that it pays tax in discharge of its own liability and not as agent for its shareholders. At one time it was thought that the company in paying tax, it did on behalf of the shareholders. But

this theory is now exploded - *Cull v. IRC* [1940] 8 ITR (Suppl.) 1 (HL) A company pays tax on its profits and having paid that tax it distributes dividends to its shareholders. Actually it is the company which is assessed and which suffers tax on its profits. It does not pay tax on behalf of the shareholders. When the shareholder receives the dividends from the company, the dividends constitute his income and he is obliged to pay tax on that income—*CIT v. Blundell Spence & Co. Ltd.* [1952] [21 ITR 28](#) (Bom.). Thus when a non-resident company earns income in a state, it pays tax to that state. But on distribution of such profit a shareholder does not become obliged to pay tax on the amount received by him as dividends only on the basis that what is received is income earned in that country, if he is not otherwise obliged under the law. The shareholder cannot be taxed unless he is resident of that state.

Paragraph 5, therefore, clarifies what is axiomatic. It rules out extra territorial taxation of dividends solely because the corporate profits from which distributions are made originate from their territory. There is, of course, no question of extra-territorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is resident of that state or to a permanent establishment or fixed base situated in that state. Paragraph 5 further provides that non-resident companies are not meant to be subjected to special taxes on undistributed profits. This paragraph, thus prevents a Contracting State from taxing dividends paid by a company resident in the other state merely because the profits or income underlying the dividends arose in the first state. It also prevents imposition of tax on the undistributed profits of a company which is resident of the other Contracting State. Philip Baker in his *Double Taxation Conventions* quoted an example of the application of paragraph 10(5), from the decision of Hoge Raad [dated September 2, 1992; (1992) *Vakstudie Nieuws* 3,407, discussed in (1993) *E.T.* 36-40]. The decision is concerned a company incorporated under Netherlands law but managed and controlled in Ireland and having no business activities in the Netherlands. The Dutch revenue authorities sought to impose a withholding tax on dividends paid by the company to its parent company in the US (in accordance with the Netherlands-U.S. Convention). The Hoge Raad, referring to the commentary to article 10(5), held that withholding tax was prohibited by that paragraph.

Dividends - Economic double taxation and distribution of dividend is distribution of profits

16.7-1 Paragraph 2 of Article 10 limits source taxation. It provides "This paragraph shall not affect the taxation of the company in respect of profits out of which dividends are paid". It is obvious because there is no identity between the company and shareholders. But difficulty arises where some states follow imputation system of taxing dividends. Classical and imputation systems are the two ways of taxing dividends in the hands of the recipient. (These are discussed later). Classical system treats the company declaring and paying dividends and the shareholder receiving it as separate and legal entities. Company pays tax on its profits. After having so done, it distributes profits amongst the shareholders as dividends, who pay tax on their own income. The nature and source are not the same in the hands of the company and the shareholder, as discussed in the preceding paragraph and recognised by paragraph 5 of article 10. The imputation system maintains some identity between the company and shareholders. It works on the premises that profits earned by a company suffers "economic" double taxation; once in the hands of the company and again in the shareholders on distribution. Under this system, therefore, the tax paid by the company is imputed to each shareholder who gets relief in respect of such imputed tax. Such system may be able to prevent economic double taxation in case of a domestic company. But it is not suited in case of other companies, especially the paying company and the recipients are residents of different countries.

Indian Income-tax Act - Exempts dividends declared by domestic companies

16.7-2 The difficulty may also arise when profit is paid as dividend. In the case *K.V. Woodend (Ceylon) Rubber and Tea Co. v. IRC* (1971) AC 321, the Privy Council held that tax imposed in Ceylon on the aggregate amount of remittances of profits made by the non-resident company is not a tax "in connection with or in lieu of the taxation of dividends."

The Indian Income-tax Act, 1961, recently exempted income received by way of dividends declared or distributed or paid by a domestic company [section 10(33)]. Domestic company has been defined to mean an Indian company, or any other company, which, in respect of its total income liable to tax under the Indian Income-tax Act, 1961 has made the prescribed arrangements for the declaration and the payment, within India, of the dividends (including dividends on preference shares) payable out of such income [see section 2(22A)]. The exemption is available if the dividends are declared and payments made within India. In the case of foreign companies or the Indian companies

which have not made arrangements for the declaration and the payment within India, such exemption is not applicable. The tax on such amounts when paid outside India are withheld in terms of the treaty provisions, and in terms of section 115A if there is no treaty. Thus, normally when a dividend is paid by a company in one country to a parent company in the other, there are two consequences :—

1. A withholding tax has to be paid to the country in which the subsidiary is located;
2. The parent company has to pay corporate tax on the dividend received; but will usually be given credit of taxes (including the withheld tax) paid in the over sea country.

Since the consequences result in economic double taxation, the withholding tax is kept low and also given credit, so that the movement of capital is not inhibited.

Dividends withholding tax - India's approach

16.8 India normally follows the UN model. The rates of withholding tax for portfolio and direct investment are negotiated. In some cases it is provided as per the OECD model. In the former case, the minimum ownership threshold for direct investment is 10 per cent; and in the latter, it is 25 per cent. Both models give rights to the state of residence and the state of source to tax the dividend income. They also demand the fulfilment of the beneficial ownership requirement if the benefit of the reduced rate of the withholding tax is to be availed. In some old Indian tax treaties none is followed. The source state has been given the exclusive right. There is no requirement of beneficial ownership. There is no mention of the rates of withholding tax [e.g., treaties with Greece, Malaysia, Syria, UAR, Libya (state in which the company is registered has the right to tax)]. In some other treaties the beneficial ownership is also not the requisite qualification, but the rate of withholding tax is further reduced if it is shown to exist. The relevant provision reads like as follows :—

"However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the dividends" (*see* article 10, paragraph 2 of the treaty with South Africa).

The requirement of beneficial ownership is thus not altogether excluded. The dividends are to be taxed at the normal rates. But if the recipient is the beneficial owner these are done at 10 per cent (*e.g.*, Netherlands), Israel, Kazakhstan, South Africa, Sweden, Turkmenistan, Vietnam), 15 per cent (*e.g.*, treaties with Japan, Kenya, Mongolia, Poland, Spain, Switzerland, Turkey and Uzbekistan), 20 per cent (*e.g.*, treaty with New Zealand). With respect to Netherlands and Switzerland, there is a provision for the modification of the rate, if in any subsequent tax treaty between India and any member of the OECD the lower rates are agreed. With respect to Netherlands necessary modification is made *vide* Notification No. 11050 [F. No. 501/2/83-FTD], dated 30-8-1999 [1999] 106 Taxman (St.) 11. This rate of withholding tax is not to exceed 10 per cent. Other treaties follow the (UN or the OECD model), as per appendix.

WITHHOLDING TAX ON DIVIDENDS - INDIAN TREATIES

<i>S. No.</i>	<i>Country</i>	<i>Rate of withholding tax (portfolio investment) (%)</i>	<i>Rate of withholding tax (direct investment) (Participation dividend) (%)</i>	<i>Level of voting control at which investor is taken direct and ceases to be portfolio</i>
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
	Armenia	10	10	-
	Australia	15	15	-
	Austria	10	10	-
	Bangladesh	15	10	10

Belarus	15	10	25
Belgium	15	15	-
Brazil	15	15	-
Bulgaria	15	15	-
Canada	25	15	10
China	10	10	-
Cyprus	15	10	10
Czech Republic	10	10	25
Denmark	25	15	25
Finland	15	15	20
France	10	10	-
			[Notification No. 11438, dated 10-7-2000, (2000) 111 Taxman 42 (St.)]
Germany	10	10	-
Hungary	10	10	10
Indonesia	15	10	25
Ireland	10	10	-
Italy	25	15	10
Israel	10	10	-
Japan	10	10	-
Jordan	10	10	-
Kazakhstan	10	10	-
Kenya	15	15	-
Korea	20	15	20
Kyrgyz Republic	10	10	-
Malaysia	10	10	-
Malta	15	10	25

Mauritius	15	5	10
Mongolia	15	15	-
Morocco	10	-	-
Namibia	10	10	-
Nepal	15	10	10
Netherlands	10	-	-
New Zealand	15	15	-
Norway	25	15	25
Oman	12.5	10	10
Philippines	20	15	10
Poland	15	15	-
Portugal	15	10	25
Qatar	10	5	10
Romania	20	15	25
Russia	10	10	-
Singapore	15	10	25
Slovenia	15	5	10
Sri Lanka (no requirement of beneficial ownership)	15	15	-
South Africa	10	10	-
Spain	15	15	-
Sudan	10	10	-
Sweden	10	10	-
Switzerland	10	10	-
Tanzania	15	10	10
Thailand			
i. In case company paying dividend is	20	15	10

an industrial undertaking			
<i>ii. In other cases</i>	Not mentioned	20	25
Trinidad	10	10	-
Turkey	15	15	-
Turkmenistan	10	10	-
UAE	15	5	10
Uganda	10	10	-
Ukraine	15	10	25
United Kingdom	15	15	-
USA	25	15	10
Uzbekistan	15	15	-
Vietnam	10	10	-
Zambia	15	5	25
(no requirement of beneficial ownership)			

Note : Any amount declared, distributed or paid by a domestic company by way of dividends has been exempt in the hands of the shareholders from the assessment year 1998-99 [section 10(33) of the Indian Income-tax Act, 1961].

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT – INTEREST

ARTICLE 11

INTEREST

1. *Interest 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 interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed . . . per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The*

competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "interest" as used in this article 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.

4. The provisions of paragraphs 1 and 2 shall 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, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to under (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or 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 or a fixed base in connexion with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State due regard being had to the other provisions of this Convention.

IntroductionIntroduction

17.1 Article 11 deals with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of the State has in the other Contracting State.

Interest is taxed in the State in which it arises and also in the State of residence of the recipient when paid. It, therefore, suffers tax doubly. The unilateral relief from double taxation, in the absence of agreement, may be inadequate and not enough to match the one which could be negotiated bilaterally. Relief from double taxation helps fostering development of international credit.

Interest may be payable (i) on investments, such as bonds or other negotiable loans or on loans granted by savers; or (ii) to banks and other financial institutions; or (iii) on purchase of goods or services on credit. In case of (i) the amount of interest represents net income of the recipient; in case of (ii) the gross amount of interest has to be reduced by the amount of interest paid by the recipient in raising the capital and the other expenses incurred on management, etc., before the recipient's net taxable income is worked out; and in case of (iii) interest charge is normally passed off to the purchaser in the form of an increase in the sale price. Thus, the taxation of interest involves questions, which country has the right to tax interest, should it be on gross or net basis; how much relief should be given by the country of residence of the lender; what should be the rate for taxation of interest on credit sales of machinery or goods, if such interest is not treated part of the sale.

The OECD Model provides that interest may be taxed in the Contracting State in which it arises, but puts a limit on the rate of tax not to exceed 10 per cent of the amount of interest. Interest charged by banks or financial institutions or payable on money borrowed for purchase of either machinery or goods or raw materials abroad, are not taxable in many developing countries. Exemption is provided to encourage industrial development.

What is subject to charge in the source State is the interest which arises in that State and is taxed according to the laws of that State.

Paragraph 1 provides that interest paid may be subject to taxation in the state of residence. Paragraph 2 entitles the source state to withhold a fixed percentage of the gross amount. The OECD model fixes the limit at 10 per cent.

The UN model leaves it to the contracting states to negotiate. Paragraph 3 defines the expression "interest". Paragraphs 4, 5 and 6 are exceptions. The taxability of interest under article 11 is excepted if the debt claim is effectively connected with the permanent establishment or the fixed base (paragraph 4); or where interest is actually paid on behalf of the establishment or the base (paragraph 5); or where the interest is not negotiated at arm's length, to the extent it is excessive (paragraph 6). The UN model is recast in the same language as the OECD model with only two changes. The OECD model has fixed the upper limit of withholding tax rate; while the UN model has left it to be established through bilateral negotiations. The UN model seeks to induct the force of attraction rule as in paragraph 1 of article 7, in paragraph 4.

Interest - Similarity between articles 10 and 11

17.2 There is a close similarity between article 10 and article 11. Both deal with financing. Article 10 deals with equity financing; and article 11, with debt financing. Equity financing results in declaration and payment of dividends; and debt financing, in payment of interest. The state of residence has the right to tax both dividends and interest. The source state has the right to retain a fixed percentage of gross income as withholding tax. For treaty access the conditions are the same in both, *i.e.*, the recipient is a person, secondly, resident, and thirdly, beneficial owner of the income. These are discussed in detail in the preceding chapter and will, therefore, not be done here.

Interest, however, unlike dividends, does not suffer double economic double taxation. It is not taxed both in the hands of the debtor and the creditor.

Interest - Residence State has right to tax

17.3 Paragraph 1 provides that the interest may be taxed in the state of the residence of the recipient. That right is not exclusive. State of source has also been given the right. The state of residence may tax it only if it has arisen in the other contracting state and has been paid to the recipient. There are two ingredients of the paragraph: (1) Interest arising in a Contracting State which is (2) paid to a resident of the other Contracting State. The first conveys that the applicability of the article is restricted to the interest income arising only in a Contracting State. It is not to be applied to interest arising in a third State and also which is attributable to the permanent establishment of the enterprise in the other Contracting State (*see* OECD Commentary, article 11, paragraph 6). As regards the second, the word "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom (*see* OECD Commentary, article 11, paragraph 5) {discussed in the following paragraph}. Unless the interest has been paid, the question of taxability will not arise. The taxability is hedged with the condition of the payment after interest having been arisen in the source state. The concept "arising of interest" will be discussed later.

Interest - Paid, meaning

17.3-1 The expression "paid" is not confined to the actual payment. It should be given a wider meaning. It also covers the amount when it is unconditionally made available to another person - *Benaras State Bank Ltd. v. CIT* AIR 1970 SC 281. An amount could be said to have been paid if the giver discharges his liability and makes the amount unconditionally available to the entitled person - *J. Dalmia v. CIT* [1964] [53 ITR 83](#) (SC). A credit balance, without more, only represents a debt and a mere book entry in the debtor's own books and does not constitute payment which will secure a discharge from the debt - *CIT v. Toshoku Ltd.* [1980] [125 ITR 525](#) (SC). However, when a creditor desires that the debtor should open an account in its name in his book of account and deal with these accounts according to its instructions, the money could be said to have been paid when it was credited - *Raghava Reddi v. CIT* [1962] [44 ITR 720](#) (SC). The concept of "payment" therefore, signifies satisfaction of a claim - *Mst. Parmeshri v. Mst. Atti* AIR 1958 Punj. 79, and means fulfilment of the obligation to place the funds at the disposal of the creditor in the manner as required by the terms of contract or in their absence by custom.

The meaning of the expression "Interest... paid to a resident of the other Contracting State" used in paragraph 1 is clarified in paragraph 2 which requires the recipient to be the beneficial owner of interest. The requirement of beneficial ownership makes it plain that "the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention" (*see* OECD Commentary, article 11, paragraph 9). The word "paid" as aforesaid, means putting funds at the disposal of the shareholder. The income is placed at the disposal of the beneficiary through the conduit of agent or the nominee. The recipient who nominally receives has no right or control over the income, which in reality belongs to the actual owner of whom such recipient is the agent, nominee, or the conduit. The income belongs to the beneficial owner and, therefore, said to have been paid to him.

Interest - Source State right to tax

17.4 Though in principle the right to tax interest belongs to the state of residence of the creditor, right has also been given to the state where it arises. Paragraph 2 provides that it may be taxed in the state in which it arises and according to its domestic law. The state may withhold tax on such income at some percentage of the gross amount (which shall not exceed 10 per cent as per OECD model and as negotiated as per the UN model), provided the recipient is the beneficial owner of the interest so charged. The concept of beneficial ownership has been discussed in details in the previous chapter and that discussion is also relevant here.

Paragraph 2 of the OECD Model was amended in 1995. The words "if the recipient is the beneficial owner of the interest" were replaced with "if the beneficial owner of the interest is the resident of the other Contracting State." It would mean that the recipient should not only be the beneficial owner but also be the resident of the other Contracting State. Thus, besides being resident, the person has to be the beneficial owner of interest. Any person resident in a Contracting State to whom that State attributes interest for purposes of its tax is the beneficial owner (*see* paragraph 159 of the Technical *Explanation* US Model). The term "beneficial owner" is not used in a narrow technical sense, rather, understood in its context and in the light of the object and purposes of the Convention, including avoiding double taxation and prevention of fiscal evasion (*see* OECD Commentary, paragraph 9). It is an anti-avoidance measure under a treaty to prevent treaty shopping. The Commentary further provides in para 10 that it would be inconsistent with the object and purpose of the Convention (avoiding double taxation and prevention of fiscal evasion and avoidance) for the State source to grant relief and exemption—

- merely on account of the status of the immediate recipient as a resident of the other Contracting State as no double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence;
- where a resident simply acts as a conduit for another person who in fact receives the benefit of the income concerned

For these reasons, the Commentary says, that the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of the Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner, if through the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

The nominal recipient is not the owner of the income. Only the beneficial owner resident is entitled to the benefit, if he is resident of the Contracting State. The requirement of the beneficial owner being resident of the contracting State having been satisfied, it is immaterial whether or not conduit is resident of the Contracting State. Even if he is not, the beneficial owner qualifies for the benefit. The interposition of an intermediary such as an agent or nominee (located in a Contracting State or in a third country) between the payer and the beneficiary may not disentitle the beneficial owner of the benefit who is resident of the other Contracting State (*see* OECD Commentary, article 11, paragraph 11).

Source State exclusive right to taxation

17.4-1 The OECD Commentary suggested that there are certain types of interest which the Contracting States may agree to the Source State having exclusive right to tax (OECD Commentary para 7.2), such as the following :

- ...◆interest paid to a State, its political sub-division and to Central Bank;
- ...◆interest paid by a State or its political sub-division;
- ...◆interest paid pursuant to export financing programmes;
- ...◆interest paid to a financial institution;
- ...◆interest on sales on credit;
- ...◆interest paid to some tax exempt entities (*e.g.*, pension funds);

The Commentary further provides in paragraph 7.11 that if the Contracting States do not wish to exempt completely any or all of the above categories of interest from taxation in the State of Source, they may wish to apply to them a lower rate of tax than that provided in paragraph 2.

Interest - Arising or deemed arising of income

17.5 The residence country is entitled to tax interest when it is paid to its resident, though it has arisen in another Contracting State. The source State has also right to tax it at the stage of its arising. Income assessable in the source State is of two kinds, viz., (i) arising, and (ii) deemed arising in that country. The concept of arising in that country although not dependent upon its receipt, is quite distinct and apart from the notion of deemed arising of the income. The word 'arises' indicates something whose origin is in the country than something brought into it - see *Thomson (Inspector of Taxes) v. Moyse* [1960] 39 ITR 35 (Ch. D). It is defined as to spring up, to come into existence - *Seth Pushalal Mansinghka (P.) Ltd. v. CIT* [1967] [66 ITR 159](#) (SC). It, therefore, means coming into existence or presenting itself and connotes the idea of the growth or accumulation with a tangible shape so as to be receivable - *Rogers Pyatt Shellac & Co. v. Secretary of State for India* [1924] [1 ITC 363](#) (Cal.). It does not mean actual receipt. It is used in contradistinction to the word 'received' or 'paid'. It only indicates a right to receive - *CIT v. Govind Prasad Prabhu Nath* [1987] [35 Taxman 513](#) (All.) and represents a stage anterior to the point of time when income becomes receivable and connotes a character of the income which is more or less inchoate - *CIT v. A. Gajapathy Naidu* [1964] [53 ITR 114](#) (SC). 'Arising' is anonymous with 'accruing' in the sense of springing as a natural growth or result.

Interest arising - Deemed Interest arising - Deemed

17.5-1 The right of the source State to tax is extended to the income even if it is deemed to arise in terms of paragraph 5 or also according to the laws of that State. If the payer of the interest is the State itself, or its resident, the interest is deemed to arise in that State irrespective of wherever it has otherwise arisen or has its source. It accords with section 9(1)(v) of the Indian Income-tax Act, 1961 which narrates circumstances when interest income is deemed to accrue or arise in India. Section 9(1)(v) reads as follows:

"(1) The following incomes shall be deemed to accrue or arise in India—

(i) to	**	**
(iv)**		

(v) income by way of interest payable by—

(a) the Government; or

(b) a person who is resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or

(c) a person who is non-resident, where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India."

Similarly, interest on account of indebtedness having connection with the permanent establishment or a fixed base is deemed to arise in the State where it is situated, notwithstanding of what the residential status of the payee is, whether he is or he is not the resident of that State. Paragraph 5 corresponds with section 9 of the Act which provides, *inter alia*, that income arising whether 'directly' or 'indirectly' through or from any business connection in India or any source in India is deemed to arise in India. The concepts of business connection under the Act of the permanent establishment or fixed base under the double taxation agreements are almost alike. A business connection involves a relation between a business carried on by a non-resident which yields profits or gains and some activity in India which contributes directly or indirectly of earning of those profits or gains - *CIT v. R.D. Aggarwal & Co.* [1965] [56 ITR 20](#) (SC), similar to the business/professional presence of a foreign enterprise in India termed as permanent establishment or fixed base.

The term 'deemed' brings within the net of chargeability the income not actually arising but which is supposed notionally to have arisen. By statutory fiction income which in no sense be said to arise at all may be considered as so arising. Similarly, the fiction may relate to the place, the person or the year of taxability.

In some agreements (as for example Indo-Malaysia), the expression used is 'derived' in place of 'arising' and 'deemed derived' in place of 'deemed arising'. The word 'derived' demands an enquiry into the genealogy of income earned as interest which stops as soon as an effective source is disclosed - *CIT v. Raja Bahadur Kamakhaya Narayan Singh* [1948] [16 ITR 325](#) (PC). If the source of interest is in India; the income is taxable in India, though it might accrue or arise elsewhere.

Interest arising - Location determinationInterest arising - Location determination

17.5-2 The place where income accrues or arises is determined from locating the originating cause namely, the source. If the originating cause is situated in a state, income becomes taxable in that state, irrespective of the residential status of the person, or the currency in which the loan is denominated or the place where the capital is employed. The place of derivation of the interest is the place where the credit is provided, *i.e.*, the place where the funds in respect of which interest is receivable are made available to the borrower. Whilst the emphasis is on the provision of credit, there are circumstances under which such credit is not of much relevance. For instance, in some cases charging of interest stems from trading transactions, when the goods are sold on deferred payment basis or on extended credit terms and interest is charged for the period of trading profits, arises in a state if the trading transactions take place in that state. In the case of mortgage, the originating cause for interest is the mortgage and, therefore, the transaction of mortgage would be decisive in establishing the place of arising of interest. The basis of charge to tax is the receipt or accrual of income, as interest. When the amount of interest is credited to a party's account, so as to make it available to him unconditionally, it could be said to have been paid to him. But merely crediting the account without making it available to the creditor does not tantamount to payment.

In *CIR v. NV Philips* [1955] NZLR 868, a New Zealand company owed a Dutch company a trade debt. It was agreed to be converted into loan, and perfected through a check drawn on UK bank account, which was forwarded to New Zealand where it was endorsed as payable to the Dutch company and then remitted to Holland. The question was whether the interest payable could be said to have a New Zealand source, as having been derived from money lent in New Zealand. Gresson J. said that in regarding the loan as the source of payment, the practical man would mean the conduct or action which was the reason for the obligation being accepted. Noth J said that a practical man of business would conclude that all income had its origin either in 'work' or in the ownership of 'property', and held that it is neither. The respondent did not perform any services in New Zealand and the income could not have a New Zealand source by virtue of being from 'work done'. Debt could not be regarded as an item of property representing the source of the interest income. Rather, it was giving of the credit which was the originating cause or the source of income received by the lender and the source of income was the business transaction carried out in the Netherlands. The "conduct and action" of the parties which brought into existence the obligation decides the location. It is the place where "credit" is given.

Paragraph 5 of the article deems interest to be arising—

- in the Contracting State where the payer is the resident, excepting if the payer has a permanent establishment/fixed and the interest is borne by, or the indebtedness is incurred in connection with, such permanent establishment/fixed place then
- in the State where the permanent establishment/fixed place is situated

Interest arising - In IndiaInterest arising - In India

17.5-3 A question arises whether interest paid on the outstanding amount due to be payable abroad in respect of the supply of an article or thing to be manufactured and delivered abroad in pursuance of an agreement transacted and signed abroad, could be said to be the income of the foreign party having arisen in India. Under the Income-tax Act income as interest is deemed to accrue or arise in India if it is payable as interest by (a) the Government, or (b) a person who is resident except where interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person outside India and non-resident if money is used for the purposes of business in India [See section 9(1)(v) of the I.T. Act, 1961]. The law is clear, it does not speak of the activity of the recipient but of the 'source', *i.e.*, the payer. The Government's right to levy and collect income-tax on the interest paid or payable to a foreign corporation is not premised upon the condition that its activity or the sale from which the (interest) income flows has situs in India. Section 9(1)(v) does not speak anything about the act or activity of a non-resident in India or place where the contract is signed. The residence of the obliger who pays the interest, rather than the act or activity of the recipient, determines the source of the interest income. If the obliger is Government or a resident in India, the interest paid by him can have no other source than India. Interest becomes payable or is paid not by the interest-bearing obligation, but by the obliger. Exception is, however, made, in case of obliger being a resident of India, that the debt or the money is borrowed and used outside India for the purpose of business/profession carried outside India. Thus, interest paid by the Government or any person under the circumstances as mentioned in section 9(1)(v) is the interest derived by the recipient from sources within India subject to income-tax. It is not the Government or that person which is to be taxed on such income, but the foreign recipient.

Interest arising where elements of contracts are most densely grouped

17.5-4 In the case of *CIT v. Saurashtra Cement & Chemical Industries Ltd.* [1975] [101 ITR 502](#) (Guj.), the assessee entered into a contract with an Italian company for the import of certain plant and machinery, under the terms, *inter alia*, that 30 per cent of the price was to be paid against bills of exchange to be drawn by the non-resident company on the assessee and to be accepted by the assessee. The assessee was to pay 6 per cent interest on the three bills on the expiry of six months from the date of issue of the bills till their maturity. It was also agreed that the price was to be paid in pounds sterling. The Income-tax Officer was of the opinion that in respect of interest payable on bills of exchange the assessee would be liable under section 9(1)(i), as an agent of the non-resident company, and made an assessment accordingly. The Appellate Assistant Commissioner held that section 9(1)(i) did not apply. The Appellate Tribunal agreed with that view. The Department appealed to the High Court. The High Court observed that the test to be applied, as laid down by the Supreme Court in *Delhi Cloth & General Mills Co. Ltd. v. Harnam Singh* AIR 1955 SC 590 is the law of the country in which the elements of contract are most densely grouped and with which factually the contract is most closely connected. The High Court observed that the non-resident company came nowhere near shores of India or territories of India, as regards performance of contract was concerned. It put the goods on board the ship concerned at a port in Europe. It received all the price in Europe in terms of foreign currency. The plant was not to be put up or erected by the non-resident company. Even the instalments were to be paid in foreign currency. So far as the unpaid price was concerned the amount was to be paid by bills of exchange drawn in a foreign country and accepted by the assessee in India. Thus, most of the elements of the contract are found to be most densely grouped with the country, namely, Italy, where the non-resident company was carrying on the business of supplying plant and machinery and hence the debt which the assessee-company owed was not an asset held by the non-resident company in India. Therefore, the interest which was payable in respect of this debt was not income arising from or through an asset held by the non-resident company in India.

Interest - Rates of withholding tax

17.6 The right of the source State to tax interest income according to its laws is not absolute. It is limited by which its tax cannot exceed. Usually the Contracting States agree to a lower rate of tax. The benefit of this ceiling or of the lower rate is available if the recipient of interest income is its beneficial owner. Agreements with India are divided into two categories according to whether right to tax has been given to (1) the source State alone; or (2) both the residence State and source State, to the former when the interest is paid to its resident and to the latter when it arises or is deemed to arise within its territories. The agreements with, Austria, Greece, Libya, Malaysia, fall in the first category, and majority others in the second.

Since income in the latter category of cases has to be shared, the rates of withholding tax should be at a reasonably low rate. The reasonableness has to be arrived at with reference to the resulting tax effect which should not go beyond what could have been the tax result with the application of the regular rates on net income. The rates of withholding tax are normally two: one, with reference to interest payable to banks or financial institutions, and the other with reference to others. The former is lower than the latter, reason being obvious. In international field interest may be paid to banks and other financial institutions. They in turn have to raise funds and loans from other investors and have, therefore, to incur expenditure on servicing those debts, besides incurring other expenditure on administration and management. The payment of interest and incurring of such expenditure result in reduction of income and the effective receipt is far less than what it could be in the hands of individual investor. The sameness of the rates of withholding tax for banks and for others causes to the former more tax suffering than what is experienced by the latter. To prevent happening such a situation and with a view to encouraging international credit, two sets of rates have been maintained; one, in the relation to banks and financial institutions and the other in case of individual investors, the former is lower than the latter. For example, Indian agreements with, Great Britain, Korea provide two rates 10 per cent and 15 per cent. Agreement with Mauritius exempts from taxation income of bank earned as interest.

Para 8 of the OECD Commentary, article 11, drew attention to the following case :

"The beneficial owner of interest arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment

company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the interest the limitation of tax which is provided in paragraph 2"

The Commentary suggested "It may be appropriate when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this article, in order to define the treatment applicable to such companies."

If the doctrine of "look through" is applied, especially in cases where such a company has been established to obtain the benefit of a treaty, it would not qualify for the benefit, as the ultimate recipients of the income are not the residents of the Contracting State but of a third State, the company acting only as a conduit.

To encourage industrial development, the developing countries generally exempt interest payable to industrial companies, apart from borrowings by Government and other public financial institutions, on money borrowed for purchase of machinery or raw materials abroad. In India, interest payable by the Government, or a local authority, Industrial Financial Corporation of India, Industrial Development Bank of India, Export-Import Bank of India, Industrial Credit and Investment Corporation of India, on the moneys borrowed outside India is not taxable. Interest is also not taxable if payable by an industrial undertaking on the amount borrowed outside India for purchase of plant and machinery, or by any financial institution for advancing loan for that purpose, or by a public company or moneys borrowed for providing long-term finances for construction or purchase of houses in India, or by the public sector company on bonds and debenture. Such or similar exemption has been provided in some of its agreements with other countries. Even without such provision, when income is not taxable in India, it cannot be made taxable by virtue of the absence of a provision in an agreement relating to exemption.

As regards the general rate, the OECD Model Convention provides for the rate of withholding tax at ten per cent of interest. It is to be applied to the gross amount. It is done for administrative convenience and for substantive reasons. But while negotiating the rate, the countries do not disregard the fact that the gross figure does not necessarily correspond to net income and that expenses have to be incurred in earning of interest. The rate negotiated approximates the usual tax rate on the net income so that the tax result by its application on the gross amount is almost the same as it would have been by the application of the usual and regular rate on the net income. The other consideration is the rate of tax in the country of the lender at which credit is to be allowed which, if it is different from the withholding tax rate, may not grant relief to the extent tax paid in the source country. The disparity in the tax rates is taken into account in establishing the final rate of withholding tax.

Interest - Mode of taxation

17.6-1 The article does not provide the mode of taxation. It may be done as per the domestic law. Tax may be levied by deduction of tax at source or by individual assessment (*see* OECD Commentary, article 11, paragraph 12). As per the Indian Income-tax Act, 1961, filing of the return is not necessary and thus assessment, provided tax has been deducted from such income [Section 115A(5) of the Act]. Further, relief in the State of source is not conditional upon the interest being subject to tax in the State of residence (*see* Commentary, para 13)

Interest - Definition of

17.7 Definition of expression 'interest' as contained in paragraph 3 of the article is exhaustive, as it goes on to define it with the help of the expression 'means'. It is defined to mean income from debt-claims. The income which originates from any debt-claim is taken to be interest income. By defining it exhaustively without reference to domestic law, the Model Convention has avoided possible dispute. The definition, however, encompasses all kinds to mean interest income, which the domestic laws could otherwise define it to so mean. Absence of the reference to domestic law has removed uncertainty about the import of 'interest' which could have been affected with the change in the domestic laws.

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 profits. In defining what constitutes 'interest', the Model Convention relies on a general wide definition coupled with specific inclusion and exclusion. The general definition gives expression or ordinary conceptions of interest while specific exclusion is designed to deal with penalties and compensation for belated payments and also interest derived from the active conduct of trade or business.

Interest - Debt-claims of every kind

17.8 The expression 'debt-claims of every kind' is of the widest import so as to take in every possible kind of claim arising out of an obligation which could be termed a debt. The word 'claims' means the common law action for the recovery of the money held to be due, *i.e.*, something recoverable by an action for debt. It does not really add to the

meaning of the word debt as the concept of 'debt' carries with it the creditor's right to enforce the recovery of the amount by an action. The expression 'debt-claims of every kind' embraces every kind of liability of a person owing to another whether in cash or kind, secured or unsecured, whether ascertained or ascertainable arising out of an obligation, expressed or implied - see *Dina Nath v. Balkrishna* AIR 1963 All. 46.

According to the OECD Commentary on article 11 para 18, term "debt-claims of every kind" obviously embraces

- cash deposits and securities in the form of money,
- government securities,
- bonds and debentures,
- mortgage interest,
- participating loans (profit sharing).

These are discussed latter.

Whatever be the form, if a transaction in substance is a transaction of loan, article 11 becomes applicable. The substance of a transaction must be a loan, *i.e.*, money lent. Penalty for late payment is not interest because it is not a remuneration for money lent.

The following items are not taken interest for the purposes of article 11 :

- ...♦interest on participating bonds considered dividend if the loan effectively shares the risk run by the debtor company (OECD Commentary, paragraph 19);
- ...♦penalty charges for late payments (OECD Model Convention, paragraph 3);
- ...♦income from non-traditional financial instruments where there is no underlying debt (OECD Commentary, paragraph 21.1);
- ...♦annuities (OECD commentary, paragraph 23)

Interest - Debt - Meaning of Interest - Debt - Meaning of

17.9 The law relating to interest arising out of 'indebtedness' is well-settled. Indebtedness means a debt owing. Bonds, securities, notes, etc., are the various forms of acknowledgement of indebtedness or in a way are certificates of such indebtedness. A debt is a sum of money which is now or will become payable in future by reason of the present obligation; *debitum in praesenti, solvendum in futuro* - *Webb v. Stenton* [1883] 11 QBD 518 (CA). There must be an existing obligation to pay a sum of money now or in future - *Union of India v. Raman Iron Foundry* AIR 1974 SC 1265. An obligation to pay arises from a promise from the debtor and such a promise must be supported by consideration - *Mrs. Ratnakumari Kumbhat v. CED* [1975] [101 ITR 572](#) (Mad.). A debt is, therefore, that one owes to another. It may be money lent or the price of goods sold and delivered or the services rendered, or the payment of rent reserved for lease, which one is bound to pay to another; a pecuniary due; a liquidated demand; a sum of money due by certain and express agreement, and includes any claim or demand upon which the payment of money or directing the payment of money can be recovered in an action. Debt denotes not only an obligation of the debtor to pay but also the right of the creditor to receive and enforce payment. To constitute a valid debt, money must have been advanced with a reasonable belief at the time of advance that it would be paid. Evidence of an obligation to repay is the first important factor to be singled out of the surrounding facts and circumstances - *CIT v. Basumal Jagat Narain* [1960] [38 ITR 447](#) (Punj.).

The expression 'debt' may take colour from the provisions of the Act. It may have different shades of meaning - *CIT v. City Motor Service Ltd.* [1966] [61 ITR 418](#) (Mad.). If money is due to a person and is not paid for but has been withheld from him after the time when the payment is to have been made, in a breach of his legal rights, it is a compensation whether it is liquidated under agreement or statute. The compensation is properly described as interest - *Kesoram Industries and Cotton Mills Ltd. v. CWT* [1966] [59 ITR 767](#) (SC). It may be regarded either representing the profit a person might have made if he has had the use of the money, or conversely the loss he suffers because he has not that use. The general idea is that he is entitled to compensation for deprivation. From that point of view it would seem immaterial whether the money is due to him under a contract express or implied or a statute or whether the money is due for any other reason in law. In either case money is due to him and is not paid or in other words is withheld from him when the payment should have been made - *Riches v. Westminster Bank Ltd.* [1947] 15 ITR 86 (Suppl.) (HL) and *Jose T. Mookan v. CIT* [1979] [117 ITR 894](#) (Ker.).

Interest - Debt a propertyInterest - Debt a property

17.9-1 Debt is property. Debt is a chose-in-action and is heritable and assignable and it is treated as property under the Transfer of Property Act which calls it 'actionable claim'. Chose-in-action arising out of contract has two aspects (i) as property and (ii) as involving a contractual obligation for performance. The property aspect is relevant for purposes of assignment, administration, and taxation and the like; the contractual aspect for performance. The debt being intangible, cannot have location unless except notionally, and in order to give it notional position rules have to be framed along arbitrary lines. In the case of a debt due to a foreigner the proper law of the contract is to be applied, *i.e.*, the law of the country in which elements of the contract are most densely grouped and with which factually the contract is most closely connected - *Delhi Cloth & General Mills Co. Ltd. v. Harnam Singh* AIR 1955 SC 590.

Interest - Unpaid purchase money - Whether debtInterest - Unpaid purchase money - Whether debt

17.9-2 Where parties enter into an agreement to accept a portion of the purchase money immediately and the balance to be paid in certain instalments along with interest on the instalment of purchase money, the agreement though it vested the property agreed to be sold in the purchaser, does not have the effect of converting the price due into loan. The intrinsic nature of the money due to the vendor is an unpaid purchase money and not as debt. The parties may, however, agree to cover the unpaid purchase money as debt - *Radha Kissen Chamria v. Keshardeo Chamria* AIR 1957 SC 743. An agreement to pay the balance consideration due by the purchase does not give rise to a loan - *Bombay Steam Navigation Co. (1953) (P.) Ltd. v. CIT* [1965] [56 ITR 52](#) (SC). When, therefore, there is no agreement initially or any novation between the parties to treat the unpaid purchase price as a debt repayable with interest, even if the purchaser incurs the obligation of paying the sale proceeds to the seller, he does not become in any sense a debtor of the seller. If there is no agreement initially or by way of novation to treat the balance of sale consideration as paid off in full and no novation to treat the balance of consideration as a loan, the amount received by the seller cannot be regarded as interest on money lent - *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP).

Detention of purchase consideration by the vendor fastens a liability upon him, in terms of section 61 of the Sale of Goods Act, to pay interest, even if he has not utilised the money - *Lakhmichand Muchhal v. CIT* [1961] [43 ITR 315](#) (MP). The interest in such case is received as part of the purchase price itself, that is to say, as part of the consideration for sale of goods on deferred payment basis and not as a separate source - *CIT v. Saurashtra Cement & Chemical Industries Ltd.* [1975] [101 ITR 502](#) (Guj.). The nomenclature assigned to such payment is irrelevant. Payment of interest if it is a part and parcel of the agreement to pay the unpaid purchase money on a deferred payment basis, there is no indebtedness, and cannot, therefore, be treated as arising from an independent source of income. Such amount bears the character of the consideration for sale - *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP).

Where, however, the payment of interest on the unpaid sale price is not a part and parcel of the transaction of sale, but is on account of an agreement to treat the unpaid price as loan, such payment arises from a transaction independent of the transaction of sale. A person carrying on business may agree with a company floated by him that the assets belonging to him shall be transferred to the company for a certain money consideration and that in satisfaction of the liability to pay that money consideration, shares of certain face value shall be allotted to the transferor. In that case there are in truth two transactions—one a transaction of sale and the other a contract under which shares are accepted in satisfaction of the liability to pay the price - *CIT v. R.R. Ramakrishna Pillai* [1967] [66 ITR 725](#) (SC). Instead, in satisfaction of the liability the redeemable loan stock is to be issued, the matter would not be different. The transaction in respect of the loan stock is transaction separate from the original transaction of sale, and, therefore, the source which is responsible for yielding interest is the transaction of loan, independent of transaction of sale - *CIT v. Assam Consolidated Tea Estates Ltd.* [1987] [167 ITR 215](#) (Cal.).

Interest - Compensation or damagesInterest - Compensation or damages

17.10 Interest is of two kinds ; that is when it is payable as compensation for the non-payment of debt on the proper day and that which is agreed to be paid on a loan. The former seems to have been allowed in equity as damages in all cases where there is a wrongful detention of money which ought to have been paid ; and the latter is allowed where the debt is secured by a bill of exchange or where promise to pay interest is implied upon a usage of trade or the like. The distinction between the two is made clear by the Supreme Court - *T. N. K. Govindaraju Chetty v. CIT* [1967] [66 ITR 465](#). Thus, when interest has been allowed under statute or under contract the same is

income exigible to tax and where it is not attributable to either statute or contract but has been awarded on a *ex gratia* basis, it would partake the character of compensation.

Interest which is merely in name but constitutes part of compensation or part of the damages, is not 'interest' chargeable to income-tax. As an integral part of such compensation it may be either slumped up with the other elements in the gross sum or may be separately stated but treated as a part of the gross sum - *IRC v. Ballantine* [1924] 8 TC 595 (C. Sess). Mere description of the amount as interest which in fact is a part of compensation does not have the effect on altering the true character of the compensation - *Simpson v. Executors of Bonner Maurice as Executor of Edward Kay* [1929] 14 TC 580 (CA). In *Ballantine's* case the liability to pay interest arose under the award of the arbitrator and in *Executors of Bonner Maurice's* case, under the Mixed Arbitral Tribunal. That, in fact, is also the position with regard to unpaid purchase money coupled with a liability to pay interest together with each of the instalment - *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP).

Interest - Amount received in exercise of a right severed from principal debt

17.11 A question may arise whether when a person assigns to another person his right to receive loan and interest after a certain period from an enterprise, the amount received by him as a consideration in excess of the principal amount would represent interest or business profit. A receipt may constitute income if it arises from an isolated business operation or commercial transaction entered into otherwise than in the course of the carrying on of the business, such operation or transaction being treated as an adventure in the nature of trade because the motive for the institution of the operation or transaction is profit-making. A contractual right to interest is not the source of interest and a contractual right severed from the principal debt is not the structure which produces interest. A sale by lender of his mere right to interest for a lump sum converts future income into present income. Many instances may be given of the sale of a capital asset for a consideration which is the income in the hands of the seller. For most part these are instances of sale of capital asset for periodic, regular or recurrent receipts, with periodicity, regularity or recurrence being characteristics of an income. Such a receipt is usually termed annuity. But there is no reason for holding conversion of capital asset into an income receipt confined to such cases.

The source of the income is the right to receive income in future. Income will bear the character of interest, if its effective source is the principal debt. A right severed from the principal debt if brings about income, that income cannot be called as interest. The event which is responsible for the arising of income is the assignment or alienation of the right *in praesenti*. The amount received in excess of the principal debt, therefore, does not represent interest, as its effective and immediate source is the transfer of a capital asset.

Interest - Amount of discount

17.12 A question arises as to whether the amount of discount charged on discounting a bill or any other instrument before its maturity or whether the difference between the sale proceeds of certificates of deposits or bill of exchange and the initial amount invested in the acquisition of such certificates or bill, would represent interest? In principle, the amount representing difference between the face value of an instrument and its maturity proceeds cannot be taken interest. Discount is not interest. Likewise the amount received in excess of initial investment in certificate deposits or before their maturity on account of the accumulation of interest over a number of years for which these certificates have been in the run, does not bear the characteristic of interest. This amount could be taken gains of investment, though in the hands of eventual holders of such certificates or bill of exchange at the time of their maturity, the sum representing the amount of investment by him and the amount actual due or received on maturity bears the characteristic of interest.

Interest - Amount paid by a thinly capitalised corporation

17.13 In a thinly capitalised corporation, the loan of money made by a shareholder may be treated as a part of the capital of the corporation. This is because where the corporate device has been used to defraud creditors to evade existing obligation, to circumvent statutes, to achieve a monopoly the courts should look upon the shareholders who have been providing necessary finances in the form of debt rather than as equity. An attempt to do business through the agency of a corporate entity without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and the court will foil that attempt by ignoring the corporate facade. The parent company becomes responsible for the debts of the subsidiary if the subsidiary has been operating for the account of its parent. If the capital of the subsidiary is trifling compared with the business to be done and the risks of loss, and the unity of interest and ownership suggest that the separate personalities of the subsidiary and the

principal do not exist, the debt of the latter is treated as equity. In such a situation the claims of the controlling shareholder (usually the holding company) may be subordinated to claims of other creditors, including the claims of the preferred shareholders in certain circumstances - *Taylor v. Standard Gas Electric Co.* 306 US 307. Debtor corporation is simply a part of the creditor's own enterprise. The matter has been discussed in the preceding chapter.

Interest - Debt secured by mortgage

17.14 After having defined interest in the widest possible import the article as a matter of caution uses the clarificatory clauses, 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 incomes from bonds or debentures'. The necessity of such a caution is felt because income from such indebtedness under the domestic laws of country, or otherwise may not be taken as arising from movable property. Though the debts, as held by Lord Atkin, exist as movable property and do not, if secured, become identified with the security or transformed into land in the one case or merchandise in the other and that separation between debt and security is well-established - *Imperial Bank of India v. Bengal National Bank Ltd.* AIR 1931 PC 245, yet the domestic laws of certain countries hold it to be income from immovable property. A mortgage is a transfer of interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt. If the purpose of the mortgage is to ensure recovery of amount, the amount received as interest cannot be taken as arising from the immovable property in case the subject-matter of the mortgage is the immovable property itself. But a mortgage with possession is an 'interest in land'. The mortgagee has a right to possession and to enjoy the benefits arising out of the land until it is redeemed. In such a case, the mortgage rights therein are immovable property - *Munilal v. Kishore Chand Kansil Ram* AIR 1927 Lahore 373. A mortgage is a transfer of an interest in specific immovable property and what the mortgagee acquires under the transaction is the mortgagor's interest in specific immovable property which can even in the case of usufructuary mortgage, only be immovable property and not movable property - *Prahlad Dalsukhrai v. Maganlal Muljibhai Tewar* AIR 1952 Bom. 454. Income arising as a result of usufructuary mortgage is subject-matter of article 6.

Interest - Bond and debentures

17.15 Certain debt-claims particularly bonds or debentures carry with them the right to participate in the debtor's profit. Such right, however, does not transform the contract of loan into the contract for carrying on the business. Participation in profits as such could be inferred from the nature of the contract. Interest on debenture or bond is a prior lien on the net income, and is payable before dividends are distributed. To that extent the holder of bond or debenture could be said possessing right to participate in the profit. Such bond may sometime be called income bond which means an obligation on which interest is paid only if earned. Some income bonds resemble preferred stock so closely that denial of interest thereon as an allowable deduction for tax purposes has been affirmed by courts. Income on bonds issued by a government utility may be secured as to principal and interest only by the expectancy of a surplus of the net operating income of future periods. However, where the nature of the contract is disguised as loan but in reality it is furnishing capital for the carrying on the business and the participation in profit rests upon a provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of loan. The definition of interest is not considered to prevent it from being treated as dividend where the lender effectively shares the risks incurred by the company and where domestic laws in the borrower's country allow for such treatment. Under certain circumstances because of the close relationship between the foreign parent company and the domestic subsidiary loan finance to the subsidiary may tantamount to equity finance. But at the same time, however, interest on participating bonds should not be regarded as dividends, nor that on convertible securities until they are converted into shares.

Interest - Bond, meaning

17.15-1 'Bond' is a generic term. It is an obligation, a contract, an agreement, to pay money or to do other thing. No precise form of words is necessary to create a bond. It is an instrument whereby a person obliges himself to pay money to another, on condition that the obligation shall be void if a specified act is performed or is not performed, as the case may be. To be a 'bond' the executor of the instrument must expressly undertake to pay money as an obligation arising out of the instrument. It shall not be a matter to be inferred. Generally accepted, the definition of 'bond' is that it is a certificate or evidence of a debt.

Interest - Debenture meaning

17.15-2 Debenture is a means of raising funds by any one but generally by companies in the interest of trade, commerce and industry. It includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not. In modern commercial usage a debenture denotes an instrument issued by the company, normally—but not necessarily—called on the face of it a debenture and providing for the payment or acknowledging the indebtedness of a specified sum at a fixed date, with interest thereon. It usually—but not necessarily gives a charge by way of security—and is often, though not invariably, expressed to be one of a series of like debentures. But the term, as used in modern commercial parlance, is of extremely elastic character.

Interest - Security, meaning

17.15-3 Security has reference to written instrument and such instruments are usually for the payment of money or to evidence a debt; it is more than a mere promise of the debtor to pay generally liability and have as collateral to such instruments pledges of property or some additional obligation. The 'security' is something beyond mere liability, the payment of which is in some way secured.

Interest - Bond, debenture and security, premium attached

17.16 Income from government securities or income from bonds or debentures is normally and generally taken as interest income. But the Model Convention has extended the concept of interest income to premium and prizes attached to such securities, bonds or debentures. Thus, the interest on these securities, bonds and debentures is the amount accruing as interest *plus* the premium paid at redemption or at issue. Premium is the amount by which the price of a security or other assets exceeds its nominal, face, par, quoted or market value. It is a reward or recompense for a particular act; a sum over and above a regular price paid chiefly as an inducement or incentive. The effective source of premium or the prize is the acquisition of securities, bond or debenture which is granted as an inducement or incentive for a person to hold them, in addition to the normal interest he would be entitled to. The nature of such premium or prize cannot be different from the nature of interest which accrues because of the indebtedness. However, the premium received not because of the indebtedness but on account of some relationship different from such indebtedness, cannot be taken interest. Bond or debenture is an asset; and if any profit arises on its transfer, such profit constitutes either a business profit or a capital gain or income falling under article 21; because the effective source of the income is transfer of the asset.

Interest - Hybrid financial instruments - Debt or equity

17.16A Hybrid instruments are financial instruments that combine some of the characteristics of equity and debt. There are also others which include features reminiscent of forward purchase contracts, options and other derivatives. Sometimes they are used to take advantage of difference between different national tax differences ("tax arbitrage"). Considerations unrelated to taxes are mainly the motives, such as regulatory considerations, cost reduction concerns or the transfer of risks. Because of the level of innovation in the financial markets and the proliferation of the new financial instruments, the traditional test of distinction between a debt and equity is insufficient. For example, a convertible bond can be analysed in several different ways :—

- ...■•debt and embedded option to convert;
- ...■•debt and warrant;
- ...■•debt and put option;
- ...■•debt and equity swap *plus* put option;
- ...■•debt and forward contract on equity *plus* put option ;
- ...■•forward contract on equity and premium.

As a general rule tax characterisation of a hybrid instrument is determined by reference to the legal and/or accounting treatment (form). A financial instrument is generally characterised by various countries by reference to its predominant character. It is either entirely equity or entirely indebtedness.

Interest - Penalty

17.17 The second sentence of paragraph 3 excludes penalty charges for late payment from the definition of interest. The word 'penalty' is a word of wide significance sometimes it means recovery of an amount as a penal measure even in a civil proceeding. An exaction which is not of a compensatory character is also termed as penalty - *Shiv*

Dutt Rai Fateh Chand v. Union of India [1984] 148 ITR 664 (SC). Interest in a wide sense is the compensation for the use or retention of another's money for the period its owner has been deprived of its use. Penalty charges for belated payments do not represent such compensation. Penalty being a punishment or a suffering, it is misnomer to call it interest. It is punishment annexed by the contract to retain lender's money beyond the contractual period. The essence of penalty is a payment of money stipulated *in terrorem* of the offending party - *Dunlop Pneumatic Tyre v. New Garage* 1915 AC 79. The obligation to pay penalty charges arises not on the basis of the same consideration for the obligation to pay interest but on account of contracted agreement, or custom or of a judgment on the happening of the act offending the agreement or custom or law.

The measure of penalty charges, even if calculated *pro rata temporis* does not do it with the interest or return on capital, as these are form of compensation different from interest charges, for the loss suffered by the creditor. The effective source is the failure of the debtor to meet the contractual or the customary statutory obligation. But the statutory interest on delayed payment of tax is interest within the meaning of this Article (*see Re Application No. P17 of 1998* [1999] 236 ITR 637 (AAR))

Interest - Debt-Claim forming part of permanent establishment

17.18 Income from every kind of debt-claims is defined to be interest income for the purposes of article 11. But that debt-claim which forms part of the assets of the permanent establishment of the beneficiary of interest or which is otherwise effectively connected with it, is an exception. Interest paid in respect of that debt-claim is taken to be income from business. Similarly, interest in respect of a debt-claim effectively connected with the fixed base of the beneficiary established for the purpose of carrying of independent personal services is taken to be professional income.

The taxability of interest income in respect of debt-claim effectively connected with the permanent establishment or the fixed base as the business or professional income depends upon the debt-claims forming part of the assets of the permanent establishment or fixed base or being effectively connected with that establishment or base. It is not based on what is known as the doctrine of the 'force of attraction'.

Paragraph 24 of the OECD Commentary, article 11, provides that paragraph 4

"does not stipulate that interest arising to a resident of a Contracting State from a source situated in the other State must, by a kind of 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 interest is taxable as part of the profits of the permanent establishment there owed by the beneficiary which is a resident in the other State, if it is paid in respect of debt-claim forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 4 relieves the State of source of the interest from any limitation under the Article. The foregoing explanations accord with those in the Commentary on Article 7"

Paragraph 4, thus, excludes from source country limitation under paragraph 2 interest paid with respect to debt-claim that forms part of the business property of a permanent establishment. Such interest is taxable on a net basis using the rates and rules of taxation generally applicable to residents of the State of source.

The doctrine of 'force of attraction' creates a fiction or presumption in relation to income arising from transactions outside permanent establishment or fixed base as if the income of the permanent establishment, *i.e.*, if a foreign enterprise has as permanent establishment in a taxing country, any other income from sources within that country is automatically regarded as income attributable to the permanent establishment. The presumption or fiction has no relevance because of the requirement of the effective connection between the debt-claim and subsequently income arising therefrom and the permanent establishment. The income is thus taxable as a part of the profit of the permanent establishment. But, however, if the effective connections is traced to the activity of the nature as described in (c) of paragraph 1 of article 7, *i.e.*, the activities of the same or similar kind as those effected through the permanent establishment, interest is taxable as business profits. The doctrine of 'force of attraction' is extended to this extent. In that case also, however, effective relation between the source of income and the activity has to be established. Effective connection will arise in a situation where interest is paid to the resident of the other Contracting State who carries on business in the state of payer through a permanent establishment situated in that

state and the debt claim is effectively connected with that permanent establishment. The concept of "effectively connected" has already been discussed in Chapter 16.

The exception as contained in paragraph 4 operates in the following situations :

- ...◆The beneficiary owner of the interest carries on business in the other State through a permanent establishment or performs independent personal services from a fixed base situated therein
- ...◆The debt-claim, the source of interest, is effectively connected with such establishment or fixed base or the business activities which are same or similar kind as those effected through the permanent establishment.

If income is not effectively connected with that business, there is no force of attraction rule to tax it. Paragraph 4, therefore, is not based to the force of attraction rule of the PE. Thus, interest is taxable in the source State as part of the profits of the permanent establishment, if it is paid in respect of debt-claim forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. The State of source is relieved from any limitations under Article 11. The requirement of "effectively connected" with the PE, the debt-claim should be genuinely connected to the business of PE carried on through a particular location (*see* OECD Commentary, paragraph 25)

Interest - Payment on behalf of permanent establishment

17.19 Paragraph 5 of article 11 deals with a fiction about where interest income arises under certain situations. It specifies that the place of residence of the payer is the source of interest. Interest is deemed to arise in a Contracting State, if the payer is the State itself; a political sub-division, a local authority or resident of that State. The second sentence of this paragraph carves out an exception to this rule. The residence of the payer will not, rather than the place of the permanent establishment or the fixed base will, be the determinative factor. If the payer of interest has contracted the loan for the needs of the permanent establishment/fixed base and interest on such loan is borne by the latter, the source of the interest is in the Contracting State in which the permanent establishment/fixed base is situated irrespective of the place of residence of the owner of the permanent establishment/fixed base even when he resides in neither of the Contracting States. The indebtedness on which the interest is paid should have some connection with the requirements of the permanent establishment/fixed base. The expression 'in connection with' implies some nexus between the two - *I.T.P. (London) Ltd. v. Winstanley* [1947] 1 All ER 177. The existence of the nexus between the indebtedness and the needs of the permanent establishment/fixed base is the essential requirement for holding the state of location of permanent establishment/fixed base as the source of interest. The absence of the nexus will render this rule inapplicable.

Thus, according to paragraph 5 interest arises in the State of which the payer is resident. There is, however, an exception; it arises in the Contracting State where the permanent establishment is situated provided the "interest-bearing loans have an obvious link with" that permanent establishment, *i.e.*, loan is contracted for the requirements of, and interest is borne by, that establishment (*see* OECD Commentary, paragraph 26). The link is obvious if the loan is contracted by the management of the establishment, or by the head office and the establishment ultimately bearing the cost (*see* OECD Commentary, paragraph 27). The exception operates if the permanent establishment uses the loan, bears its cost and is situated in the Contracting State. If situated in the third State, the interest would be deemed to arise in the State where the payer is resident.

Interest - And the doctrine of arm's length

17.20 Paragraph 6 echoes the doctrine of arm's length. It restricts the operation of article 11 in cases where the amount of interest which would have been agreed upon between the payer and the beneficial owner of the interest had they stipulated at arm's length. It provides that where by reasons of special relationship between the payer and the beneficial owner or between both of them and some person, the amount of the interest exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of article 11 apply only to the last-mentioned amount and as for the excess the laws of each Contracting State are applicable having regard to the other provisions of the convention. The question is whether such excess be considered as a dividend on the amount of loan representing equity contribution. For that matter reference to article 9 is necessary.

Article 9 of the Model stipulates that 'where conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprise' then 'any profits which would but for those connections have accrued to one of the enterprises, but by reasons of

those conditions have not so accrued' should be included in the profits of the enterprise and taxed accordingly. Whether this clause is 'restrictive' or is 'illustrative', there has been difference of opinion. As for the thin capitalisation the rule has been that it should not normally have the effect of increasing the taxable profits of the domestic enterprise to any amount greater than the arm's length profit. Article 9 is relevant not only in adjusting the rate of interest but also in certain circumstances to determining whether what is presented as loan be considered as contribution to equity capital or the amount of interest be taxed as profit or be taken as belonging to any other category for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention.

Paragraph 6 is applicable only if the excess payment of interest is the result of a special relationship between the payer and the beneficial owner or between them and some other person. Special relationship becomes evident where one of the persons to the contract is under the influence or control of the other or *vice versa*. Relationship by blood or marriage or dictated by mutuality or community of interest as distinct from legal relationship giving rise to the payment of interest is also covered by the concept special relationship. The concept of "special relationship" is wider than of the "associated enterprises" under article 9. Further, article 11 is concerned with the interest charged in excess of what would have been done in the absence of special relationship, and not with this characterisation. Amount of interest, corrected and not the characterisation of the loan as a contribution to equity capital.

Interest - India's approach

17.21 The rate of withholding tax set out in Indian treaties is normally 15 per cent. In some, it is further reduced when the recipient is bank. In some cases, interest is exempt when it is paid to the Government of the Contracting State. Treaties with Greece and Libya give the exclusive right to tax the source State. The UAR treaty provides that it is taxable in the State of which the payer is the resident. In the Appendix is given a summary of rates of withholding tax in various Indian treaties.

APPENDIX - WITHHOLDING RATES OF TAX IN RESPECT OF INTEREST

<i>Country</i>	<i>Rate of withholding tax (%)</i>	<i>Rate of withholding tax in case of bank (%)</i>	<i>Exemption in case of Government</i>	<i>Remarks</i>
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Armenia	10	as may be mutually agreed	Yes	
Australia	15	-	-	
Austria	10	-	Yes	-
Bangladesh	10	-	Yes	
Belarus	10	-	Yes	-
Belgium	15	10	-	
Brazil	15	-	Yes	
Bulgaria	15	-	Yes	
Canada	15	-	Yes	
China	10	-	Yes	
Cyprus	10	-	Yes	

Czech Republic	10	-	Yes	
Denmark	15	10	Yes	
Finland	10	-	-	
France	10	-	Yes	(2000) 111 Taxman 42 (St.)
Germany	10	-	Yes	
Hungary	10	as may be mutually agreed	Yes	
Indonesia	10	-	Yes	
Ireland	10	-	Yes	
Israel	10	-	-	
Italy	15	-	Yes	
Japan	10	10	Yes	
Jordan	10	-	Yes	-
Kazakhstan	10	-	Yes	
Kenya	15	-	Yes	
Kyrgyz Republic	10	-	Yes	-
Korea	15	10	Yes	
Malaysia	10	as may be mutually agreed	Yes	
Malta	10	-	Yes	
Mongolia	15	-	Yes	
Mauritius	Not mentioned	-	Yes	
Morocco	10	-	yes	
Namibia	10	-	Yes	-
Nepal	15	10	Yes	
Netherlands	10	10	Yes	(1999) 239 ITR

				(St.) 56
New Zealand	10	-	Yes	(2000) 242 ITR (St.) 147
Norway	15	-	Yes	
Oman	10	-	Yes	
Philippines	15	10	Yes	
Poland	15	-	Yes	
Portugal	10	-	Yes	-
Qatar	10	0	yes	
Romania	15	-	Yes	
Russia	10	-	Yes	-
Singapore	15	10	-	
Slovenia	10	-	Yes	
South Africa	10	-	Yes	
Spain	15	-	Yes	
Sri Lanka	10	-	Yes	
Sudan	10	as may be mutually agreed	Yes	
Sweden	10	-	Yes	
Switzerland	10	10	Yes	
Syria	7.5	-	Yes	
Tanzania	12.5	-	Yes	
Thailand	25	10	Yes	
Trinidad and Tobago	10	-	Yes	-
Turkey	15	10	Yes	
Turkmenistan	10	-	Yes	
UAE	12.5	5	Yes	

UK	15	10	Yes	
Uganda	10	as may be mutually agreed	Yes	
Ukraine	10	-	Yes	-
USA	15	10	Yes	
Uzbekistan	15	-	Yes	
Vietnam	10	-	Yes	
Zambia	10	-	Yes	

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - ROYALTIES

ARTICLE 12

ROYALTIES

1. *Royalties 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 may also be taxed in the Contracting State in which they arise and according to the laws of that State but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.*
3. *The term "royalties" as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.*
4. *The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to under (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.*
5. *Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in*

connection with which the liability to pay the royalties was incurred and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

IntroductionIntroduction

18.1 Scope of income derived from investment has been discussed in paragraph 16-1 of Chapter 16. Cooperation of capital and services with the infrastructure results in the generation of income as dividends, interest or royalties. Capital and services are provided by the country of residence, and the management, labour, work, efforts, by the country of source. Both the countries, therefore, have legitimate claim and agree to share income. Rules for distribution of dividend income are discussed in Chapter 16, and for interest, in 17. For royalties, these are contained in article 12 and are discussed in this Chapter.

The article deals with taxability of royalties arising from the use of intangible properties such as copyrights, patents, and of other properties such as industrial, commercial or scientific equipment, or information concerning industrial, commercial or scientific experience. In the era of industrialisation the real wealth consists in holding intangible assets, in contradistinction to traditionally holding of tangible assets, such as houses, chattels, and money. Now intellectual property has been becoming more and more important than the tangible and the physical assets. Consideration for the use of these assets (royalties or fee for technical services) is taxed both in the country in which it arises and in the country of which the recipient is resident. What is taxed in the royalty or fee is its character of remuneration for the assets and not the latter in themselves. In the absence of a treaty each country would assert its jurisdiction to tax the income.

It has now been well recognised that royalties from licensing of technology is having the source where the licensed property is put to use. For taxing income from the exploitation of industrial asset the attention is focused to the country where the asset is used to generate income and not where it is formed and developed. Though the source country has jurisdiction to tax income in regard to royalty income, the claim of country of residence cannot be ignored. The OECD Model Convention, however, has given an exclusive right to residence State. The expression used is "shall be taxable only in the other Contracting State". The UN Model uses the word "may" in place of "only". It departs substantially in recognising the principle of taxation at source. This Model recognises that the taxing jurisdiction depends on the nexus between it and economic activities producing income on the one hand and also on the relationship between it and the taxpayer on the other. The Model, however, limits the rights of the source country to tax at a certain agreed upon percentage of the gross amount. The expression "royalties" has been defined exhaustively as representing consideration for the use or right to use copyright, patents, industrial equipment (not included in the OECD Model) or information. Income, however, if it could be referred to a permanent establishment or a fixed base becomes taxable as business, or professional income, irrespective of its source being the copyright, etc.

Paragraph 1 outlines the basic rule that royalties may be taxed in the state of residence. Paragraph 2 entitles the state of source to tax income only to limited extent of withholding some percentage of the gross amount as tax. Paragraph 3 defines the term "royalties". Paragraphs 4, 5 and 6 contain exception. Paragraphs 4 and 5 except payment of royalties which has connection or relation with permanent establishment or the fixed base, in which case article 7 or 14 applies; Paragraph 6 excepts payment which is found in excess of what is determined by the application of the arm's length rule. In that case the domestic laws of the state applies to the excess. Paragraph 5 of the UN Model does not find place in the OECD Model.

Royalties - State of residence right to taxRoyalties - State of residence right to tax

18.2 Paragraph 1 provides that state of residence may tax royalties arising in the other state. That right is not exclusive as in the OECD model. State of source may also tax it, as provided in paragraph 2. The state of residence will be able to tax, if income is paid to recipient. Receivability without having it been received is of no avail. The expression "paid" has been discussed in paragraph 17.3-1 of Chapter 17. That discussion is relevant here also.

There are two ingredients of the paragraph: (1) royalties arising in a Contracting State which is (2) paid to a resident of the other Contracting State. The first conveys that the applicability of the article is restricted to the royalties arising only in a Contracting State. It is not to be applied to royalties arising in a third State and also which is attributable to the permanent establishment of the enterprise in the other Contracting State (*see* OECD Commentary, article 12, paragraph 5). As regards the second, the word "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom (*see* OECD Commentary, article 12, paragraph 8) {discussed later}.

Royalties - State of source right to tax

18.3 Paragraph 2 is the corollary of paragraph 1, extending the right to the state of source. That right is, however, limited. It is not to extend beyond some agreed percentage of the gross amount to be withheld. That rate is normally lower than the usual which is applicable to such income. For access to treaty and benefit of the lower rate, what is necessary to be established is that the recipient is a person, secondly, resident, and thirdly, a beneficial owner of the income. These concepts are discussed in detail in chapter 16. These are also relevant here.

The taxability in the Source State does not depend, unlike the taxability in the residence State, on whom the royalties are paid. These are taxed according to the domestic laws. In India income is taxable on receipt or cash basis, but also on accrual basis. Thus, when an income is credited to a foreign company, it becomes taxable and tax is required to be deducted in terms of section 195(1) of the Indian Income-tax Act [*Flakt (India) Ltd., In re* (2004) [267 ITR 727](#) (AAR)].

The meaning of the expression "Royalties... paid to a resident of the other Contracting State" used in paragraph 1 is clarified in paragraph 2 which requires the recipient to be the beneficial owner of interest. The requirement of beneficial ownership makes it plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. Paragraph 1 of the OECD Model Convention itself provides that royalties should be beneficially owned by a resident of the other Contracting State. UN Model and OECD Model, therefore, both require that royalties should be beneficially owned.

The words "if the recipient is the beneficial owner of the interest" convey that the recipient should not only be the beneficial owner but also be the resident of the other Contracting State. Thus, besides being resident, the person has to be the beneficial owner of royalties. Any person resident in a Contracting State to whom that State attributes royalties for purposes of its tax is the beneficial owner (*see* paragraph 174 of the Technical *Explanation* US Model). The term "beneficial owner" is not used in a narrow technical sense, rather, understood in its context and in the light of the object and purposes of the Convention, including avoiding double taxation and prevention of fiscal evasion (*see* OECD Commentary, article 12, paragraph 4). It is an anti-avoidance measure under a treaty to prevent treaty shopping. The Commentary further provides in para 4.1 that it would be inconsistent with the object and purpose of the Convention (avoiding double taxation and prevention of fiscal evasion and avoidance) for the State source to grant relief and exemption—

- merely on account of the status of the immediate recipient as a resident of the other Contracting State as no double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence;
- where a resident simply acts as a conduit for another person who in fact receives the benefit of the income concerned

For these reasons, the Commentary says, that the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of the Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner, if through the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

The nominal recipient is not the owner of the income. Only the beneficial owner resident is entitled to the benefit, if he is resident of the Contracting State. The requirement of the beneficial owner being resident of the contracting State having been satisfied, it is immaterial whether or not conduit is resident of the Contracting State. Even if he is not, the beneficial owner qualifies for the benefit. The interposition of an intermediary such as an agent or nominee (located in a Contracting State or in a third country) between the payer and the beneficiary may not disentitle the

beneficial owner of the benefit who is resident of the other Contracting State (*see* OECD Commentary, article 12, paragraph 4.2).

Para 7 of the OECD Commentary, article 12, drew attention to the following case:

"....the beneficial owner of royalties arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to dis-tribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the royalties the tax exemption which is provided in paragraph 1"

The Commentary suggested "It may be appropriate when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this article, in order to define the treatment applicable to such companies."

If the doctrine of "look through" is applied, especially in cases where such a company has been established to obtain the benefit of a treaty, it would not qualify for the benefit, as the ultimate recipients of the income are not the residents of the Contracting State but of a third State, the company acting only as a conduit.

The word "paid" as aforesaid, means putting funds at the disposal of the taxpayer. The income is placed at the disposal of the beneficiary through the conduit of agent or the nominee. The recipient who nominally receives has no right or control over the income, which in reality belongs to the actual owner of whom such recipient is the agent, nominee, or the conduit. The income belongs to the beneficial owner and, therefore, said to have been paid to him.

The word "payment" has a very wide meaning since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or custom.

Royalties - State of source-tax baseRoyalties - State of source-tax base

18.3-1 The jurisdiction of the source country to tax royalty income being not in doubt, the question arises about the taxable base, whether and to what extent or whether not at all, the expenses associated with the royalties be allowed deduction. Such expenditure must have been incurred outside the jurisdiction of the source country and may involve different years. Since allocation of expenditure relating to the royalties income is pregnant with some inherent uncertainties and difficulties, taxing it by the source country by the use of the method of applying a withholding tax on the gross amount is advantageous. Such advantage is recognised world over because of the certainty in result, and simplicity in administration. But the rate of deduction of tax at source be such so as to approximate overall relationship of the expenses to gross royalty, so that overall revenue will approximate to the results that would be reached through the application of regular rate of tax to the net royalty income. This is on account of the well established principle that expenses giving rise to profits are to be allowed to be deducted. In view of this principle, the Indian Income-tax Act, 1961 provides, *inter alia*, that deductions admissible in computing the income by way of royalties received from Government or an Indian concern in pursuance of an agreement made with a foreign company before 1-4-1976, should be limited to 20 per cent of the gross amount of such royalties income (section 44D). The net amount thus arrived at was to be taxed at the flat concessional rate of 40 per cent. However, no deduction of expenditure is permissible in respect of income received in pursuance of agreement after 1-4-1976, (but before 1-4-2003) though rate of tax has been reduced to 20 per cent. Under both the methods the overall revenue results work out to be almost same. The source state has the right to withhold tax if royalties arise therein and according to its laws. The rate of tax is now ten per cent.

Royalties - ArisingRoyalties - Arising

18.4 The right of the source state would be operative if royalties arise in that state. The concept of income "arising" in India has been discussed in details in paragraphs 17.5, 17.5-1, 17.5-2, 17.5-3, 17.5-4 of Chapter 17. These may be referred to in the context of royalties also, with the only change that section 9(1)(v) (of the Income-tax Act, 1961) wherever referred may be substituted with section 9(1)(vi) (for royalties) and 9(1)(vii) (for fees for technical services).

A non-resident taxpayer is chargeable to tax in India in respect of income by way of royalties which is received or is deemed to be received in India or which accrues or arises or is deemed to accrue or arise in India. The Income-tax Act did not contain clear cut source rule specifying the circumstances in which royalty income could be regarded as accruing or arising in India. Further, lump sum payments made for the supply of know-how were not chargeable to tax where such know-how was supplied from abroad and the payment therefor was made outside

India, even though the know-how is used in India, if no part thereof was attributable to any services rendered in India before the Finance Act, 1976 inserted clause (vi) in section 9(1), clause (vi) specifying the circumstances in which the royalties income is deemed to accrue or arise in India. Under this clause royalty income of the following types will be deemed to accrue or arise in India :

- ◆ Royalty payable by the Central Government or any State Government
- ◆ Royalty payable by a resident, except where the payment is relatable to a business or profession carried on by him *outside India* or to any other source of his income *outside India*
- ◆ Royalty payable by a non-resident if the payment is relatable to a business or profession carried on by him *in India* or to any other source of his income *in India*.

The concept of deemed accrual or arisal of royalties under the DTA are almost the same. Under para 5 of article 12, the royalties are deemed to arise in a Contracting State where the payer

- ◆ is that State itself; or
- ◆ is the resident of that State; or
- ◆ has a permanent establishment or fixed base in that State in connection with which the liability to pay the royalties was incurred.

The concept of deemed accrual or arisal of royalties under section 9 of the Indian Income-tax Act and the DTA is that it is related to the residence of the person paying the royalties or, irrespective of such residence, it is relatable to the business or profession carried on by the person. Section 9 deems royalty to accrue or arise in India, *inter alia*, where it is payable in respect of the right, property, or information used for the purposes of making or earning of any income from any source in India ; there being no reference to the person who is liable to pay the royalty or a business carried on by him in India. What is sufficient is that the property in respect of which royalty is payable is used to earn income from any source in India. The condition about the use of the property is found in the Indo-US agreement. Under that agreement it is, *inter alia*, provided that royalty is deemed to arise in the State :—

- ◆ if the person paying the royalty is a resident of that State; or
- ◆ if the person paying the royalty has a permanent establishment or a fixed base there in connection with which the liability to pay royalty is incurred and the liability is borne by such establishment or base; or
- ◆ if the royalty relates to the use of, or the right to use, the property which gives rise to the royalty in that State.

Thus, if the royalties do not arise in India because the first two above mentioned conditions are not satisfied, *i.e.*, neither the payer is resident of, nor does he have permanent establishment in, India, these would be deemed to arise if they relate to the use of or the right to use of the property in India [see *Advance Ruling in P. No. 22 of 1996, In re (1999) 238 ITR 99 (AAR)*].

In view of the aforesaid royalty income consisting of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of any data, documentation; drawings or specifications relating to any patent, invention, model, design, secret formula or process or trade mark or similar property, is ordinarily become chargeable to tax in India. In order, however, to ensure that foreign suppliers of technical know-how who had entered into agreements or had finalised proposals for the receipt of such lump sum royalties with the approval of the Central Government on the understanding that such payment would be exempt from income-tax, it was provided that such lump sum payments received under *approved* agreements made before 1-4-1976 would not be deemed to accrue or arise in India for that purpose. An agreement made on or after 1-4-1976 would be deemed to have been made before that date if the following conditions are fulfilled:

- ◆ In the case of a taxpayer other than a foreign company, if the agreement was made in accordance with proposals approved by Central Government before that date;
- ◆ In the case of a foreign company, if the conditions referred to above was satisfied, and the foreign company had exercised an option by furnishing a declaration in writing to the Income-tax Officer that the agreement might be regarded as having been made before 1-4-1976. The option in that behalf would have to be exercised before the expiry of the time allowed under section 139(1) or section 139(2) (whether fixed originally or on extension) for furnishing the return of income for the assessment year 1977-78 and or the assessment year in which the royalty income first became chargeable to tax, whichever assessment year is later. The option so exercised would be final not only for the assessment year in relation to which it is made but also for every subsequent year.

The intention of giving an option to foreign companies to claim that agreements made on or after the 1st April, 1976 are regarded as agreements made before the date is that where exemption from income-tax in respect of lump sum royalty is allowed, the balance of the royalty income would be charged to tax at the rates applicable in the case of such income derived under approved agreements made before that date. In other words, taxpayers exercising the option are placed on par with taxpayers deriving royalty income under approved agreements made before 1-4-1976 in all respects.

As in the case of royalty the Finance Act, 1976 also amended the Act specifying in clause (vii) of section 9(1) in the circumstances in which the income by way of 'fees for technical services' is deemed to accrue or arise in India, in the same manner.

Under clause (vii), income by way of 'fees for technical services' of the following types will be deemed to accrue or arise in India :

- ◆ Fees for technical services payable by the Central Government or any State Government
- ◆ Fees for technical services payable by a resident, except where the payment is relatable to a business or profession carried on by him outside India or to any other source of his income outside India.
- ◆ Fees for technical services payable by a non-resident if the payment is relatable to a business or profession carried on by him in India or to any other source of his income in India.

The expression 'fees for technical services' is defined to mean any consideration (including any lump sum consideration) for the rendering of managerial, technical or consultancy services (including the provisions of services of technical or other personnel). It, however, does not include fees of the following types, namely :

- ◆ Consideration received for any construction, assembly, mining or like project undertaken by the recipient. Such consideration has been excluded from the definition on the ground that such activities virtually amount to carrying on business in India for which considerable expenditure will have to be incurred by a non-resident and accordingly it will not be fair to tax such consideration in the hands of a foreign company on gross basis or to restrict the expenditure incurred for earning the same to 20 per cent of the gross amount as provided in new section 44D. Consideration for any construction, assembly mining or like project will, therefore, be chargeable to tax on net basis, *i.e.*, after allowing deduction in respect of costs and expenditure incurred for earning the same and charged to tax at the rates applicable to the ordinary income of the non-resident as specified in the relevant Finance Act.
- ◆ Consideration which is chargeable to tax in the hands of the recipient under the head "Salaries".

Royalty - Meaning

18.5 The term 'royalty' has been defined in paragraph 3 of article 12 of the UN Model as to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films or films or tapes used for radio or television broadcasting any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

The scope of the income from royalty has not been confined to industrial royalties arising out of patents and know-how, copyright royalties but also extended to cover rentals within its scope such as film rentals, rentals of certain equipment and current technical assistance. Rentals of tangible assets such as commercial or scientific equipment should normally have been taken as business income, but since these are to be taken royalty income as per paragraph 3 of article 12 of the UN Model, these may, therefore, create confusion. This confusion could be dispelled if the tangible assets referred to in aforesaid paragraph be understood as those which represent invention or technical know-how in the tangible form.

The OECD Model has, however, removed the confusion by deleting words "payments received as a consideration for the use of, or the right to use, industrial, commercial or scientific equipment". Taxation of income as royalty is confined in that model to the payments made in respect of the use of the intangibles which are monopolistic in character. For the use of the tangible assets such as equipment it is taken as business income, being the rent.

Royalty - Generally defined

18.6 Defined generally, the word 'royalty' means a share of the product or profit reserved by the owner for permitting another to use the property; the share of the production or profit paid to the owner; a share of the product or proceeds therefrom reserved to the owner for permitting another to use the property; the share of the

produce reserved to the owner for permitting another to exploit and use the property; a share of the profit, reserved by the owner for permitting another to use the property; the amount reserved or the rental to be paid to the original owner of the whole estate (Corpus Juris Secundum, Vol. 77; p. 542). 'Royalty property' is a share of product or profits reserved by the owner for permitting another to use or develop his property, and a case of one of the American Courts is referred to in support of this proposition in Corpus Juris Secundum. 'Royalty' (except in the expression 'tonnage royalty') includes a dead rent and any periodical or other payment for minerals got under a mining lease, and 'tonnage royalty' means a royalty calculated by reference to the amount of minerals so got from time to time, or of manufactured articles produced from such minerals, or by any similar method (words and phrases legally defined, Vol. V, P. 354).

The royalty is a payment made to the owners of certain types of rights by those who are permitted by the owners to exercise the rights. The rights concerned are literary, musical and artistic copyright, rights in inventions and designs, and rights in mineral deposits, including oil and natural gas. The term originated from the fact that in Great Britain for centuries gold and silver mines were the property of the Crown; such 'royal' metals could be mined only if a payment ('royalty') were made to the Crown. An individual inventor without capital or plant must licence others to manufacture his invention. When owners of rights make arrangements for such exploitation by others, the remuneration they receive in exchange is often in the form of a royalty, usually based on the actual extent of the exploitation. As to inventions, a royalty may be said to be a compensation paid under a licence granted by the owner of a patent ('the licensor') to another person ('the licensee') who wishes to make use of the invention, the subject of the patent. The patent remains the property of the licensor. A licence may be exclusive in which case the patent owner precludes himself from granting licences to third parties, or non-exclusive, in which case the patent owner may grant licences to as many persons as he wishes. The granting of licences and the payment of royalties thereunder are purely a matter of contract between licensor and licensee. It is essential that all relevant matters be provided for in the contract, especially the amount of royalties, and the precise method of computing them. A licence may be limited or not, according to the intentions of the parties. It may be limited to certain purposes or to geographical areas or in any other way permissible under the national laws having jurisdiction over the transaction. It will normally be for the full term of the patent. A royalty may be a single payment covering the whole use of the patent for the whole term, but the more usual practice is to make periodic payments and to relate the amounts of those payments to the actual use of the patent by the licensee. It is common to charge royalties on the basis of a percentage of the price for which the licensee sells the articles or on the basis of the number of the articles made under the patent. Although the amount of royalties is generally a matter of free bargaining between licensor and licensee, in some countries governments preclude their nationals from paying royalties to foreign patent owners in excess of a certain maximum fixed by the Government. Some Governments also reserve the right to approve the entire licence contract concluded between their nationals and aliens.

Royalty payments may be in exchange for something in addition to the mere use of the invention. The most common example is that wherein the licensor not only grants the right to use the invention but also undertakes to supply the licensee with technical 'know-how', that is to say, information from his own experience on the most efficient and economical way of working the patent. It is estimated that more than 50 per cent of licence contracts include 'know-how provisions'.

When applied to industrial designs, the meaning of the word 'royalty' is roughly the same as in the case of patented inventions. Designs, depending on their nature or the various national laws, may be protected by patents, copyright on registration. The form of legal protection, however, does little to change the system of royalty payment as described in regard to patent (Encyclopaedia Britannica, 1972 edn., Vol. 19, p. 676).

It is thus clear that in the case of secret processes, patents, special inventions, when right of exploitation is given by the owner of the inventions, patents, etc., to a third party, instead of outright sale, then, for the right to exploit these inventions, secret processes, some amount may be paid and the amount paid may be co-related to the extent of exploitation. It is in this sense, that licence agreements for the exploitation of patents, inventions, etc., are being entered into in modern commercial world and as part of such agreements, even knowledge derived from his own experience and technical know-how for the most economical and efficient user of the patents inventions, etc., are parted with by the licensor to the licensee—*CIT v. Ahmedabad Mfg. & Calico Printing Co.* [1983] [139 ITR 806](#) (Guj.).

Royalties - Mine, quarry, etc., taxed as income from immovable property or as business
Royalties - Mine, quarry, etc., taxed as income from immovable property or as business

18.7 Under some agreements income earned as royalty is taxed as arising from immovable property, if it is derived from the operation of mine, quarry or any other extraction of natural resources. The provision reads as follows :

"Income from immovable property may be taxed only in the territory in which the property is situated. For this purpose any rent or royalty or other income derived from the operation of a mine, quarry or any other extraction of natural resources shall be regarded as income from immovable property."

For a limited purpose 'royalty' derived from mine, quarry or any other extraction of natural resources is taken to be emanating as if from an immovable property along with rent of other income. This article only classifies that the nature of receipt derived from that particular source as royalty. It, thereafter, states that receipt designated as royalty should be taxed as income from immovable property.

Nothing can in this article lead to interpretation that the general meaning which is to be attributed to 'royalties' requires to be limited to royalties derived from mines, quarries, or any other extraction of natural resources.

In fact income referable to mine or a quarry or any other place of extraction of natural resources, is to be assessed as business income, as the UN Model Convention defines, *inter alia*, to include these to mean permanent establishment. The nomenclature of a receipt as 'royalty' would not be decisive as characterising it to be so, if the receipt is having reference to the permanent establishment. In that case it is to be taxed as business income, and not as royalty convertible under article 12 or as arising from immovable property taxable under article 6.

Royalties - Defined in double taxation agreements

18.8 Royalty has been defined in double Indian taxation agreements, to mean any royalty or the like amount received as consideration for the right to use copyright, models or artistic designs, plans, secret processes, formulae and other like property. In almost all agreements the definition and concept of royalty as per OECD/UN Model, has been incorporated. The modern international usage in the commercial field accepts this very meaning of the word 'royalty' in the sense of consideration paid from time to time or, may be outright, for the exploitation of the rights, *inter alia*, to the knowledge regarding secret process, patents, registered trade marks, etc., and also the right to market the products as a result of those exploitations. These agreements were arrived at in the field of taxation and the word 'royalty' is thus understood by the contracting parties, namely, the respective countries—*CIT v. Ahmedabad Mfg. & Calico Printing Co.* [1983] [139 ITR 806](#) (Guj.).

Paragraph 3 of article 12 defines 'royalty' exhaustively as to mean payments of any kind received as a -

(a) consideration for the use of, or the right to use,

- i. any copyright (of literary, artistic or scientific work including cinematograph films, or films or tapes for radio or television broadcasting); any patent, trade mark, design or model, plant, secret formula or process; or
- ii. industrial commercial or scientific equipment; or

(b) consideration for

- Information concerning industrial, commercial or scientific experience.

The definition covers payments of any kind received as a consideration for the right to use the property or for the use of information. "Payments of any kind" must have relation to the use of the property or information. The definition covers—

- payments made under a license, and
- compensation which a person would be obliged to pay for infringement of the right

(see OECD Commentary, article 12, para 8)

Technology (and also copyright) and know how are assets which yield income as royalty; (a) above basically deals with technology, and (b) with know-how. Royalty, therefore, relates to use of :

1. Technology;
2. Technical know-how;
3. Copyrights;

and represents

4. Consideration for 2, and in respect of 1 and 3 above.

Royalties - Technology meaningRoyalties - Technology meaning

18.9 Technology is defined as the method by which something is produced or achieved. It is a scientific or organised knowledge concerning technique, and in a broad sense includes engineering. According to the new Encyclopaedia Britannica (15th edition), "technology" may be defined as the systematic study of techniques for making and doing things. The term itself, a combination of Greek *techne*, "art, craft" with *logos*, "word, speech", meant in Greece a discourse on the arts, both fine and applied. When it first appeared in the 17th century, it was used to mean a discussion on the applied arts only. Gradually these arts themselves came to be the object to the designation. By the 20th century, the term embraced a growing rate of means, processes and ideas in addition to tools and machines. By the second half of the century, technology was defined by such phrases as "means or activities by which man seeks to change or manipulate his environment". Even such broad definitions have been criticised by observers who pointed out the increasing difficulty of distinguishing between scientific inquiry and technological activity. The Webster dictionary describes the term well, namely its origin is a Greek term, *technologia*, which comes from a Greek term *techne*, meaning the systematic treatment of an art or skill. The 1994 dictionary describes it as "the practical application of knowledge especially in a particular area; engineering" or "a manner of accomplishing a task especially using technical processes, methods, or knowledge" (Webster's 10th New Collegiate Dictionary). The Webster's 1990 edition has a broader definition, "the totality of means employed to provide objects necessary human sustenance and comfort". It is viewed as systematic or practical knowledge, experience or skills used for (i) mainly of products or application of process (ii) commercial and management purpose in industry, and, (iii) the achievement of any desired result, be it in industry or social areas of life. Its basic strategies are; an instrument for industrial resource into utilitarian products, as a tool for conditioning environment, as a resource for channelising wealth, (iv) as a medium for bringing socio-economic change, as a determinant factor in development, as a trade product.

Technology-embodied in various formsTechnology-embodied in various forms

18.9-1 Technology is embodied in various forms, such as machinery, human capital and written documents. It falls within two broad categories :

- (1) intangible property, and,
- (2) know-how.

Intangible property relates to manufactured products, software, or manufacturing process. Such property is evidenced by a patent, copyright or similar legal protection from infringement (discussed in paragraph 18.10)

Know-how relates to product or manufacturing processes, which is not generally known and not patented or copyrighted (discussed in paragraphs 18.10-5 and 18.10-6). The focus of the chapter is on the transfer of technology, rather than transfer of tangible products resulting from technology.

Technology Transfer - licensingTechnology Transfer - licensing

18.9-2 Transfer of technology involves industrial properties like patents and trade marks, human skills and equipment.

It normally falls within (a) license of technology, (b) provision of know-how, and (c) sale of technology.

In general contractual agreement can be divided into two broad types; pure and applied technology. The first includes what are generally known as licensing agreements and involves the transfer of rights to use certain properties such as patents, trade marks, design, model, plan, secret formula or process. Applied technology includes industrial, commercial and scientific equipment. Use of, or the right to use, technology for a consideration on licence is the classical transfer of technology. That consideration is defined as royalty (industrial royalty). It includes copyright also (literary royalty). There are thus two elements of the technology transfer. In one, technology is transferred in the pure form (patent, design or model etc.). In the other it is transferred in the applied form (equipment). The OECD model, however, does not treat payment in respect of industrial, commercial and scientific equipment as royalty. It is, therefore, deleted it from the definition. Such payment is now treated, as per model, as business receipts to be taxable as per rules contained in articles 5 and 7. Besides equipment, there is another state of the applied form. It is known as know-how. It is an information concerning industrial, commercial or scientific experience. Consideration paid for such information (know-how) is also defined as royalty besides consideration is for the use or the right to use of the property. In a licence for the use, no absolute transfer is involved. Such is not the case in a transfer of the technical know-how.

Technology transfer - Provision of know-howTechnology transfer - Provision of know-how

18.9-3 Imparting technical know-how results in transfer of or parting with the special knowledge which would ripen into a form of property (*Moriarty v. Evans Medical Supplies Ltd.* [1959] [35 ITR 707](#) (HL)). The following are the characteristics of the provision of technical know-how:

- impart of know-how enables the other party to use it for his own account;
- the person so imparting is not required to play any role in the application of the formula granted to the licensee and to guarantee the result thereof;
- impart of the know-how is not providing services in which case the service provider undertakes to use his customary skill of his calling to execute the work himself for the other party.

Technology transfer - Sale of technologyTechnology transfer - Sale of technology

18.9-4 Technology may be supplied through the absolute sale of patent rights. A sale occurs when the transferor relinquishes to the transferee all rights associated with the technology. A payment for the absolute assignment and ownership of rights transferred is not a payment for the use of something belonging to another party, and, therefore, is not royalty. The consideration received for such transfer is not royalties and not taxed as such. It is taxed as business income or as capital gains. The cost of acquired patent rights is deductible from the gross taxable sale proceeds.

Technology transfer - Sale and license distinctionTechnology transfer - Sale and license distinction

18.9-5 To decide whether sale or license, what is to be seen the nature of parting of rights, whether it is in the nature of "parting of asset" or only in the nature of its "employment in trade" [*see CIT v. Cilag Ltd.* [1968] [70 ITR 760](#) (Bom)]. The former is capital receipt attracting capital gains tax [*see Evans Medical Supplies Ltd. v. Moriarty* [1959] [35 ITR 707](#) (HL)]; *CIT v. Ralliwolf Ltd.* [1983] [143 ITR 720](#) (Bom); the latter, royalty *Rolls - Royce Ltd. v. Jeffery* [1965] 56 ITR 580 (HL).

The key operative term for sale is a transfer of all substantial rights in the property. Retained rights are critical determinant of whether substantial rights have been transferred. A licensee has no interest in the property. His right is only to do or continue to do something, which, in the absence of that right, would be unlawful. Licence is, thus, a permission given by the patentee to work the patent, otherwise it would be illegal (*see Heap v. Hartley* [1889] 6 RPC 495). The legal ownership over the patent is not parted with. It continues with the patentee. Only permission is granted to make use of the patent. A licensee may have the exclusive right to do so. The License may be exclusive ; non-exclusive or bare".

Licensing could be with regard to property. A sale is the absolute assignment of the intellectual property. The licensing is with regard to property. Property is not the subject-matter of assignment. What is assigned is some interest with regard to it. An act is said to have been done with regard to something if it has relation or reference to that something. That something is not itself the subject-matter.

Technology transfer - Mode of payments not decisive of capital or revenue receiptTechnology transfer - Mode of payments not decisive of capital or revenue receipt

18.9-6 The nature and the form of the technology and the manner of transfer is important. The mode of receipt of the consideration is not relevant. It may be lump sum or periodical. In *Rolls Royce Ltd. v. Jeffrey* (Inspector of Taxes) [1965] 56 ITR 580 (HL), the House of Lords held that the lump sum received for the know-how is revenue receipt. That decision was followed in *Musker v. English Electric Co. Ltd.* 41 TC 556 (HL) as well as *Murray* (Inspector of Taxes) v. *Imperial Chemical Industries Ltd.* [1969] 71 ITR 661 (CA). In the *Imperial Chemical Industries* case, Lord Denning M.R. held that lump sum for know-how may be revenue receipt as the capital remained with the owner and all he did was to put it to use. However, when trader or manufacturer sells his know-how outright to a purchaser and agrees not to use the know-how to the prejudice of the purchaser, the receipt is capital in his hands—*Fenner Woodroffe & Co. Ltd. v. CIT* [1976] [102 ITR 665](#) (Mad.). Thus if the imparting of know-how is in the nature of services rendered without anything more, the receipt is treated as revenue, But, when the consideration is received for imparting the know-how in association with disposal of capital asset, the receipts is capital—*CIT v. Ralliwolf Ltd.* [1983] [143 ITR 720](#) (Bom.).

The question, therefore, whether income from the transfer of technology by a non-resident is of capital or revenue in nature, depends on whether the consideration is for the absolute assignment and ownerships of rights or for

granting merely a license in respect of the property. There are many case laws on the question of capital revenue, besides quoted above :

- The fact that payments are made in a lump sum does not automatically make them capital. Equally, payments made in instalments are not automatically income (*IRC v. British Salmson Aero Engines* and *Foley v. Fletcher* 7 WR 141);
- Payments of a percentage of receipts to a non-resident as consideration for the exclusive use of a secret formula is of revenue in nature (*Delage v. Nugget Polish Co. Ltd.* 21 TLR 454) ;
- Payments received by traders in connection with their business are of an income nature even when paid in lump sum form (*Mackenzie v. Arnold* 33 TC 363);
- Consideration for an outright disposal of technology is likely to be capital in nature (*Nethersole v. Withers* 28 TC 501) ;
- If the transferor retain title to the property which generates the receipt, then the receipt is more likely to be of an income in nature (*Hobbs v. Hussey* 24 TC 153);
- The accounting treatment of any receipt may be helpful in determining their nature (*Johnston v. Britania Airways Ltd.* (1994) STC 763);
- Consideration for exclusive licences may be capital, whereas payments for non-exclusive licences are more likely to be income (*British Salmson and Nethersole v. Withers*).

To sum up

- (a) Where there is a partial transfer of rights in techno-logy, whereby the user either adapts or reproduces the technology for purposes of onward distribution, the payments are likely to be income and specifically royalties or licence payments.
- (b) If all the rights are transferred outright the payments will not be royalties. They may be capital receipts subject to capital gains tax or revenue income derived pursuant to a trade.

Pfizer Corporation casePfizer Corporation case

18.9-7 In a case before the Authority for Advance Rulings [*Pfizer Corporation, In re* [2004] [271 ITR 101](#) (AAR)], there was a transfer of documents containing know how and technical information to a non-resident company of Denmark and the question was whether the payments received was taxable in India. The Authority ruled—

- that, since there was no Double Taxation Avoidance Agreement between India and Denmark, the transaction had to be covered under the domestic law;
- that the transfer of technical information in the form of dossier was a transfer of capital asset;
- that once the Indian company entered into agreement with the Denmark company for early termination of agreement to manufacture the products, the technical information reverted to the applicant and there was extinguishment of right for which consideration has been paid to the Indian company;
- that the situs of the technical information which was the subject-matter of the sale of agreement was not in India. The receipt from transfer of technical information in the form of dossier in Bangkok was a receipt on transfer of capital asset and was not chargeable to tax in India under section 5(2)(1) with section 9(1)(i) of the Indian Income-tax Act, 1961, as the asset was situated outside India.

The facts of the case are: the applicant Pfizer Corporation Panama (PC) a non-resident company, is a part of Pfizer Group. It owned the technology information pertaining to the manufacture of nutritional food supplement product manufactured and sold by Pfizer India, another group company, under "Protinex" and "Dumex" trade marks registered in India. Under an arrangement, the Indian company has been using the technology information in respect of the above-mentioned products without payment of royalty. A Denmark company acquired from the applicant the trade marks and technology information by two separate agreements for—

- (1) early termination of the license granted to the Indian company to manufacture under the said trade marks; consideration paid was US \$ million;
- (2) purchase of technology information (in the form of dossier, handed over in Bangkok); consideration paid was US\$ 5 million.

The AAR has found that the technology information was owned by the applicant, used in India for a very long period, almost exclusively, and, therefore, available in India in the form of dossier as well as intangible form. It was held to be chattel and was a capital. It relied on the decision of the Supreme Court in *Associated Cement Companies Ltd. v. Commissioner of Customs* [2001] 124 STC 59 and *Scientific Engineering House (P.) Ltd.* [1986] [157 ITR 86](#). As regards situs of the asset, it observed :

"As regards the situs of the asset which is the subject- matter of transfer, it is admitted that the said asset was available in India, both in tangible as well as intangible form before the transfer to EAC (Denmark). It is also not disputed that for a very long time the said information was almost exclusively used in India and improvements and improvisations in the said information were made in India. However, it is also not disputed that the Indian company was only a licensee and the original technical know- how was always available with the owner, *i.e.*, the applicant. Once the Indian company entered into an agreement with EAC Denmark for early termination of license to manufacture these products the technical know-how reverted back to the owner and there was extinguishment of the right to manufacture for which consideration has been paid to the Indian company. As a result no asset related to technical know-how was located in India either in tangible form or intangible form after the termination of the licence granted to the Indian company. The subsequent agreements between EAC Trading P. Ltd., an Indian affiliate of EAC Denmark and Pfizer India to have business support during the initial period of EAC Trading's operations in India do not affect the situs of transfer. We are of the view that the situs of the technical information which is subject to transfer of the sale agreement was not in India in any form after early termination of licence."

The above observations contain many contradictions and do not lead to the conclusions arrived at, for the reasons as discussed below:

It appears that the Indian company was an exclusive, and not a bare, licence holder for the geographical territory of India which it had been exploiting under the trade marks "Protinex" and "Dumex" registered in India. Exclusive licence means a licence from the owner of the patent which confers on the licensee to the exclusion of all other persons any right in respect of the patented invention. The grant of exclusive licence *pro tanto* disentitles the owner from exercising his rights therein (*see CIT v. Ralliwolf Ltd.* [1983] [143 ITR 720](#) (Bom.); *Moriarty v. Evans Medical Supplies Ltd.* [1959] [35 ITR 707](#) (HL) and *U.S. Valves Inc. v. Robert F. Dray* (decided by United States Court of appeal for the Federal Circuit on May 22, 2000). It is different from non-exclusive or bare licence which confers no legal standing on the licensee. A bare licence is covenant by the patent owner not to sue the licensee from making, suing or selling the patented invention and under which a patent owner reserves the right to grant similar licences to other entities. An exclusive licensee receives more substantial right than a non- exclusive licensee, but receives fewer rights than an assignee of all substantial rights. For example, an exclusive licensee could receive the exclusive right to practice an invention within the given territory [*see Rite-Hit Corp. v. Kelley Co. Inc.* 56 F.3d 1538; 35 USPQ 2d 1065 (1995)]. A patentee may grant—

- (1) the whole patent; or
- (2) the exclusive right under a patent within or throughout a specified part of the territory

A transfer of any of these two kinds of interest is an assignment and vests in the assignee a title in so much of the patent itself, with a right to sue infringer. The Indian company in the present case, had the exclusive licence for the territory of India and been practising the invention under the trade mark "Protinex" and "Dumex" registered in its name, with a right to sue in case of the infringement of the said trademark and the invention. It was the owner of the patent so far as Indian territory is concerned. Pfizer Corporation Panama had no right whatsoever, in so far as the territory of India is concerned. The Indian company was the owner by its own rights. It transferred that right to the Denmark company for a consideration of US \$ 7 million, under an agreement. There was no extinguishment but a transfer of ownership together with trademarks, and thus no "reversion" of any right to the Pfizer Corporation. The Denmark company became owner of the right to exploit the invention within the territory of India under the said agreement.

As regards situs, the Authority observed that the situs of technology information was, at the time of transfer, situated in Bangkok, without a supportive finding whether it was registered there. A patent is situate in the country where it is registered (*see English, Scottish & Australian Bank Ltd. v. IRC* [1932] AC 238). Similarly, a trademark is situate in the country where it is registered. The subject-matter of transfer of the said agreements was transfer of Indian company ownership of the invention in so far as the territory of India (the exclusive licence to work the invention within the territory of India) and the ownership of the trademarks registered in India. After transfer it

appeared to have been exploited within the said territory of India (the Authority had observed that "The subsequent agreements between EAC Trading P. Ltd., an Indian affiliate of EAC Denmark Trading's operations in India do not affect the situs of the technical information"). The situs of the invention, therefore, in so far as India is concerned was situate in India. The Authority had itself earlier observed that the situs of the asset which is subject-matter of transfer, the said asset was available both in tangible and intangible form and the technical information for a very long time was almost exclusively used in India. After having so said, it concluded that it did not exist in India.

The confusion appears to be due to the fact that according to the Authority the technology was a chattel as it was in the form of a dossier and the transfer of the document is the transfer of technology. It mainly relied on the decision of the Supreme Court in *Associated Cement Companies Ltd. v. Commissioner of Customs* [2001] 124 STC 59. That was a case under the Customs Act where the expression "goods" has been defined in a wide term, covering every kind of movable property, having a value irrespective of what it consists of or contains. Such an article is chattel which may be a paper or document or diskette containing the technological advice; the constituents or the contents or their quality being of no importance. Thus, what is being subject to customs duty is not the intellectual input but the goods whose value is enhanced by the said input. The focus of the Customs Act is not on the intellectual input but on the final product; while under the Income-tax Act, it is not on the paper but on the technological advice and the transfer of the right in respect thereof. The document on which the technology is scribed is not the technology itself. Its transfer is not the transfer of ownership of technology with all its incidents, such as, the right to produce and sell the product, the right to change the underlying work, the right to transfer licence its use to other, the right transfer the copyright itself. The distinction is well explained by an analogy between the copyright and copyrighted article (discussed in detail later).

The matter has not been correctly ruled. The Indian company received lump consideration of its right to exploit the technology in so far as Indian territory is concerned, being the exclusive licensee and thus owner, it represented royalty. It is not a capital receipt.

Royalties - Technology is a legally protected industrial property

18.10 Royalty broadly means exploitation of what are called intellectual properties. Such properties are intangible, having no physical existence. Their value is limited by the rights and anticipative benefits that possession confers upon the owner. Intellectual property, therefore, connotes a string of rights available for the protection and exploitation of technology, designs, secrets etc. They include two branches *i.e.*, industrial property, and copyright. Industrial property chiefly covers patents, rights in technological inventions, rights in trade mark, industrial designs etc. Copyrights cover music artistic, literary, photographic words, etc. Such property has come to be known as intellectual property because it is born of the intellect and requires for its exploitation and use, again intellect. The intellectual property is unique in that it is devised by the individual out of his own ingenuity. It relates to literary, artistic and scientific words; inventions in all fields of human endeavour; scientific discoveries; industrial designs; and all other activities in the industrial, scientific or artistic fields. Rights in respect of such inventions and creations are legally protected. Know-how is also viewed as representing a property right that is capable of being protected. It is different from basic types of information or pure services which happen to be technical in nature. For such services what is paid as consideration is called technical fee. Strictly speaking such fee is not royalty. Some countries treat it at par with royalty. Royalty is payment in respect of legally protected right which is monopolistic in character, such as patent or copyright. A copyright is the result of work of art or any other work involving originality and creativity. A patent for invention is the result of inventive skill. A design relates to the shape or configuration of a finished article. A trade mark is not always the result of inventive skill or a product of imagination but it may be a word or devise of some common place thing used or proposed to be used on the goods to be manufactured by a person. Trade marks are protected against imitation. Intellectual property protects application of ideas and information that are of commercial value in corpus of the new knowledge. Law favours protecting the intellectual property from its unauthorised exploitation and use or imitation. The object of protecting it is to enable its acquirer to secure a fair value of investment of his intellectual efforts, capital and labour. Various branches of intellectual property law (patents, trade marks, designs, copyright), confer legal exclusivity in the marketplace. The law in India relating to intellectual property and to the protection of its rights of its exploitation and use are the Patents Act, 1970, Trade and Merchandise Act, 1999, Designs Act, Copyright Act, 1957.

As aforesaid, industrial property relates to invention and technology and exists in the form patent, design, trade mark, model and technical know-how. Copyright property relates to literary, musical or artistic or scientific work;

software included. These are discussed in the following paragraphs :

Royalties - Patent

18.10-1 Patent is a grant by the Government to an inventor, giving him the exclusive right to make, produce, use and sell his invention, for a term of years. It is an official document conferring a right or privilege, the monopoly of the right or privilege so granted.

Royalties - Design

18.10-2 Design means only the nature of shape, configuration, pattern or ornament applied to any article by an industrial process or means - *King Features v. Klee man* [1941] AC 417.

Royalties - Trademark

18.10-3 It is a distinctive identification of a manufactured produce or of a service taking the form of a name, sign, motto, device or emblem. It is thus a distinctive mark attached to goods or services to identify them with a particular trader or with his successor as the owner of the particular business - *M.R. Varma v. William Holling & Co. Ltd.* AIR 1947 Lahore 29.

Royalties - Model

18.10-4 A pattern, system, or postulational set of functional relations, including definitions, between variable and parameters, the purpose of which is to conceptualize empirical findings and to plan, design and analyze the results of systematic investigations. Sometimes models may take physical form (e.g., scale models or ships or buildings) as an aid to planning or analysis, but more frequently they retain the form of abstract constructs. Often thought of as being confined to investigations in mathematical and developed sciences, models are essential to systematic work in any field dealing with complex problems involving, relations between facts and objectives - *Eric L. Kohles*; A Dictionary for Accountants.

Royalties - Technical know-how

18.10-5 Technical know-how is a term of wide connotation and includes several kinds of technical knowledge, assistance and services. There are several ingredients constituting technical know-how such as (i) the design of the product to be manufactured, (ii) the design of the process of manufacture, (iii) the design and engineering of the plant, (iv) the erection of and the commissioning of the plant etc. Know-how is peculiar kind of asset. It is the accumulated fund of knowledge acquired by years of observation, research, experimentation and experience. Though it is intangible asset, the whole of it, however, is not in an intangible form, as it grows in the shape of formula, drawings, patterns, blue prints, specification and so on - *Kirloskar Pneumatic Co. Ltd. v. CIT* [1982] [136 ITR 746](#) (Bom.), *CIT v. S.L.M. Manecklal Industries Ltd.* [1977] [107 ITR 133](#) (Guj.). The material form it takes not only facilitates preservation, collation and nearly reference, but also makes it perceptible and visible and easily capable of being transmitted to others. When it assumes such a concrete shape, it ceases to be intangible asset and becomes in a sense of corporate asset which can be bought and sold, lent or borrowed, exchanged or stolen or imparted to others. Though physical records of know-how such as lists, drawings, engineering and manufacturing data is imparted to another person, know-how is not lost to its owner who still continues to retain it for his own use. Therefore, income arising from an agreement under which such record is parted with cannot properly be termed as capital receipt. Technology is a science or a body of knowledge applicable to the production of goods or services. Modern machinery is the product of technology. The concept of transfer of technology is complex phenomenon involving rights, obligations, privileges and commitments of the parties concerned. The transaction permits access to advance means of production and control over the means of production. Such control, however, is not always accompanied by control over technology. This is only when the skill, information and technical excellence that make up technology, is transferred to the national managers, supervisors, and workers of the enterprise from where it can eventually be permeated into the economy of the developing country, technology could be said to have been transferred. Such transfer is possible if access and use of commercial and scientific equipment is permitted. Consideration paid for the transfer of know-how is therefore, defined in the tax treaty as meaning royalty. For the purpose technical know-how means knowledge concerning industrial, commercial or scientific experience. It is the undivulged technical information whether capable of being patented or not, that is necessary for the industrial production of a product or process, directly and under some conditions, inasmuch it is derived from experience - *Advance Ruling P. No. 30 of 1999* [1999] [105 Taxman 240](#) (AAR - New Delhi). Know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the process of technique. It has traditionally been viewed as representing property rights that is capable of being

protected to guard against unauthorised disclosure. The grant of such a right brings the know-how transfer closer to transaction involving, for example, a patent. Know-how transfers are generally viewed as involving transfer of pre-existing special knowledge or information to another, where such knowledge or experience remains confidential and the property of the supplier. He does not guarantee results. He takes no part in the implementation or use of the information in the recipient's business.

18.10-5a KNOW-HOW SALIENT FEATURES - The salient features of technical know-how are:—

- ◆ It is a pre-existing special knowledge and information concerning industrial, commercial or scientific experience, not developed for a particular contract;
- ◆ It is capable of being patented as representing property, similar to a patent;
- ◆ The knowledge or information is not publicly available. It is confidential and secret;
- ◆ Its supplier does not play role in applying the information and also does not guarantee the results;

The OECD Commentary on article 12 refers to the following key elements to identify transactions for the provision of know-how :—

- ◆ according to the ANBPPI (Association des Bureaux pour la Protection de la Propriete Industrielle), know-how is "undivulged technical information that is necessary for the industrial reproduction of a product or process, directly and under some conditions, inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique".
- ◆ in the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remains unrevealed to the public".
- ◆ in the know-how contract "the grantor is not required to play any part himself in the application of the formula and.... does not guarantee the results thereof".
- ◆ the provision of know-how must be distinguished from the "provision of services, in which one of the parties undertakes to use customary skills of his calling to execute work himself for the other party".

The following examples are not to be considered to be received as consideration for the provision of know-how, but rather, for the provision of services :—

- ◆ payments obtained as consideration for after-sale service,
- ◆ payments for service rendered by a seller to the purchaser under a guarantee,
- ◆ payments for pure technical assistance, and
- ◆ payments for an opinion given by an engineer, an advocate or accountant.

Also refer to discussion in the following paragraph.

Royalties - Technical know-how, technical services and technical assistance

18.10-6 One significant development in the taxation of the technology transfers is the expansion of the royalty category to include the supply of information not previously viewed as rising to the level of, or not provided under the conditions previously viewed as similar to the standards of, know-how. The latter type of information supply is referred to as technical assistance or "brain work and technical services" Technical services or technical assistance were historically viewed as constituting a provision of services rather than transfer of technological information. These were not often subject to tax in importing countries because services are performed abroad. In many countries it remains crucial to distinguish property as representing know-how and services constituting technical services or assistance. A service is characterized technical assistance when a person rendering it undertakes to use the customary skills of his calling to execute work himself for the other party until its full execution, which is guaranteed as consequence of the services rendered. In the case of technical know-how the licensor is transferring the right to use certain confidential information and knowledge which is to be used by the licensee in its business activity on his own account and at his own risk without licensor guaranteeing results. The performance of technical services or technical assistance does not, therefore, involve the transfer of previously developed information, but instead of performance of services at that time or the modification of the pre-existing data to fit the particular needs of the customer. It may be taxed where the services are performed, the place where the services are used or the residence of the payer of the service fees. There has been a trend to combine these categories of income and to treat

payments made for technical services or technical assistance as royalties. In India, it is defined to include managerial, technical or consultancy services, technical information to be used by a business in India, or importing of information concerning the use of scientific work or industrial property rights. Technical services fees is subject to tax in virtually the same manner as royalty. It is very difficult to distinguish whether information is in effect a form of property right, or whether the information is technical. In some cases distinction has to be made between technical services and technical assistance.

The performance of technical services or technical assistance does not involve the transfer of the pre-developed knowledge, as in the case of the transfer of the know-how. In transfer of know-how the supplier takes no part in the implementation and does not guarantee results. Technical service transactions call for the supplier to use its own skill in reaching an agreed - upon result for the other party. The other party does not receive a transfer of the underlying knowledge or skill.

18.10-6a TECHNICAL SERVICES - SALIENT FEATURES - Salient features of Technical services are :—

- ◆ Technical services involve one party using its own skill to perform services for another without any transfer of that skill to the other party;
- ◆ The supplier undertakes and guarantees result.

Thus, by technical services, it could mean services requiring expertise in a technology. The technical service could be in the form of advisory service. In that case it is called consultancy services. According to paragraph 4(b) of article 12 of the Indo-US agreement, technical or consultancy services refer to the services which are made available to the persons requiring the service of technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. Generally speaking, technology will be considered "made available" when the person acquiring the services is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc., are made available to the person purchasing the service. Similarly, the use of a product which embodies technology shall not *per se* be considered to make the technology available. Typical categories of services that generally involve either the development and transfer of technical plans or technical designs or making technology available include engineering services, architectural services, and computer software development (*see* US-India Tax Treaty, Memorandum of Understanding, dated May 15, 1989). Technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to the areas mentioned in the said Memorandum of Understanding. It then proceeds to give a number of illustrations to indicate what kinds of cases paragraph 4(b) of the tax treaty will be applicable and in what kinds not [*see* (1991) ITR (St.) 139].

18.10-6b SUPPLY OF KNOW-HOW AND RENDERING OF SERVICES - DISTINCTION FEATURES - The distinction between supply of know-how and rendering of services has already been discussed in the preceding paragraph. The Technical Advisory Group set up by the Fiscal Affairs Committee of the OECD (the TAG) in para 29 of its report dated the 1st September considers that the following criteria, developed in a ruling by the Australian Tax Office, may be useful to distinguish between payments for services and for supply of know-how :

- ◆ under the contract for supply of know-how :—
 - (a) a "product" (*i.e.*, knowledge, information, technique, formula, skills, process, plan, etc.) which has already been created or developed or is already in existence is transferred ;
 - (b) the product which is the subject of contract is transferred for use by the buyer (*i.e.*, it is supplied); and
 - (c) except in the case of a disposition where the seller divests himself completely of any further interest in the product, the property in the product remains with the seller. All that is obtained by the buyer is the right to use the product. Subject to the terms of the contract, the seller retains the right to use the product himself and to transfer it to the others.
- ◆ in contrast, in the contract involving the performance of services :—
 - (d) the contractor undertakes to perform services which will result in the creation, development or the bringing into existence of a product (which may or may not be know-how) ;
 - (e) in the course of developing a product, the contractor would supply existing knowledge, skill and expertise - there is not a transfer (*i.e.*, supply) of know-how from the contractor to the buyer as such but a

use by the contractor of his knowledge for his own purpose; and

- (f) the product created as a result of the services belongs to the buyer for him to use without having to obtain any further rights in respect of the product. However, in the course of rendering services the contractor would, in most cases, also produce as a by-product a work (*e.g.*, plan, design, specification, report, etc., which would contain knowledge, etc., not otherwise known to the buyer and which may or may not be protected by patents etc.) in which copyright would subsist. Unless specifically agreed otherwise, the contractor is the owner of such copyright and the buyer or any other person is, by law, precluded from using the property in which the copyright subsists for any purpose other than the purpose for which it was originally designed without first obtaining the approval of the contractor. This would not alter the nature of the contract which would remain one for the performance of services.
- ◆ another very important factor is the incidence of cost; *i.e.*, both the level and the nature of the expenditure incurred by the seller :—
 - (g) in most cases involving the supply of know-how which is already in existence there would appear to be very little more which needs to be done by the supplier other than to copy existing material (...) On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure.
 - (h) a contract for the performance of services would, depending on the nature of the services rendered, involve the contractor in such items of expenditure as salaries and wages to employees engaged in researching, designing, testing, drawing and other associated activities, payments to sub-contractors for the performance of similar services, etc.
- ◆ these factors all point to the one main distinctive feature of know-how that it is an asset and, as such, it is something which is already in existence and not something brought into existence in pursuance of the particular contract.

As for criteria to distinguish payments for services and payments for technical know-how as regards e-commerce transaction related to computer software, refer to paragraph 18.11-3.

Fees for Technical Services Fees for Technical Services

18.10-7 The term "fees for technical services" have been generally defined in the DTA as meaning "consideration for the services of a managerial, technical or consultancy nature, including the provision of services of technical or other personnel" (*see* agreement between India and Romania). "Managerial, technical or consultancy services" is the expression used in other agreements such as with Belgium, Canada, Czechoslovakia, Denmark, Finland, Germany, Hungary, Japan, Korea, the Netherlands, New Zealand, Norway, Poland, Sweden, the USSR, and Israel. Technical services mean services requiring expertise in a technology.

Consultancy services mean advisory services. Consultancy service could also be a technical service. Managerial services mean services requiring expertise in industrial or business management techniques. Thus, managerial services mean services by persons having knowledge and experience, industrial or business management techniques, and technical services, services requiring expertise in a technology. Consultancy services mean advisory services relating to managerial or technical matters.

The Madras High Court in *Skycell Communications Ltd. v. Dy. CIT* [2001] [251 ITR 53](#) held :

"Having regard to the fact that the term is required to be understood in the context in which it is used, "fee for technical services" could only be meant to cover such things technical as are capable of being provided by way of service for a fee. The popular meaning of the word 'technical' is involving or concerning applied and industrial science.

In the modern day world, almost every facet of one's life is linked to science and technology inasmuch as numerous things used or relied upon in every day life is the result of scientific and technological development. Every instrument or gadget that is used to make life easier is the result of scientific invention or development and involves the use of technology. On that score, every provider of every instrument or facility used by a person cannot be regarded as providing a technical service."

The court illustrated the point by the following examples—

- When a person hires a taxi to move from one place to another, he uses a product of science and technology, *viz.*, an automobile. It cannot be on that ground be said that the taxi driver who controls the vehicle, and

monitors its movement is rendering a technical service to the person who uses the automobile;

- When a person travels by a train or in an aeroplane, it cannot be said that the railways or airlines is rendering a technical service to the passenger;
- When a person travels by a bus, it cannot be said that the undertaking which owns the bus is rendering technical service to the passenger;
- The electricity supplied to a consumer cannot, on the ground that generators are used to generate electricity, transmission lines to carry the power, transformers to regulate the flow of current, meters to measure the consumption, be regarded as amounting to provision of technical service;
- The internet is very much a product of technology, and without the sophisticated equipment installed by the internet service providers and the use of the telephone fixed or mobile through which the connection is established, the service cannot be provided. However, on that score, every subscriber of the internet service provider cannot be regarded as having entered into a contract for availing of technical service from the provider of the internet service.

The Court, therefore, observed that facilities such as use of telephone fixed or mobile, the cable T.V., the internet, the automobile, the railway, the aeroplane, consumption of electric energy, etc., when used by individuals are not capable of being regarded as technical service. It held :

"‘Technical service’ referred to in section 9(1)(vii) (Income- tax Act, 1961) contemplates rendering of ‘service’ to the payer of the fee. Mere collection of a ‘fee’ for use of a standard facility provided to all those willing to pay for it does not amount to the fee having been received for technical services."

The Authority for Advance Rulings (AAR No. 475/1999) observed,

"technology would be considered made available when the person acquiring the service is enabled to apply the technology embedded in the services provided by him. The mere fact that the provisions of the service may require technical input by the person providing the service would not *per se* mean that technology has been made available. Similarly, the use of a product, which embodies technology, shall not *per se* constitute technology being made available."

The provider of such services is not required to play any part himself in the application of the technology and he does not guarantee the result thereof. This is different from the services provided by a professional person in which he undertakes to use his customary skill of his calling to execute work himself for the other party. For example, income from the design of a refinery by an engineer (even if the engineer employed know-how in the process of rendering the design) or the production of a brief by a lawyer is not the income from the transfer of know-how. It is the income from services taxable under Article 14 or Article 15. Professional services may, however, be embodied in property that gives rise to royalties. Technical or consultancy services does not include general educational training of the user's employees, nor does it include information developed especially for the user, for example, a technical plan or design developed according to user's application.

Royalties - Consideration for industrial, commercial, or scientific experience Royalties - Consideration for industrial, commercial, or scientific experience

18.10-8 Know-how includes technical information that is conveyed through technical or consultancy services. Consideration for it is termed royalties. Consideration for information, concerning industrial, commercial or scientific experience is also termed as royalties. The term "industrial, commercial, or scientific experience" (sometimes referred to as "know-how") has the meaning assigned to in paragraph 11 of the OECD Commentary on Article 12. It states that the term alludes to the concept of "know-how". The term may include information that is ancillary to a right otherwise giving rise to royalties, such as patent or secret process. Royalties does not include payments for professional services (such as architectural, engineering, managerial, or software development), in which the service provider undertakes to use the customary skills of his calling to execute work himself for his employer. Thus, payments obtained as consideration for after-sale service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for opinion given by an engineer, an advocate or accountant, do not constitute royalties (see paragraph 11 of the OECD Commentary on Article 12). The commentary further provides:

"Such payments generally fall under Article 7. In business practice, contracts are encountered which cover both know and provision of technical assistance. One example, amongst others, of contracts of this kind is that

of franchising, where the franchiser imparts his knowledge and experience to the franchisee and, in addition, provides him with the varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration for treatment applicable to the principal part."

Royalties - Copyrights

18.11 Copyright means exclusive right in relation to a literary, dramatic, musical, artistic work, a cinematography film, a sound recording, computer software programmes, to do or otherwise doing any acts as specified in section 14 of the Indian Copyrights Act, 1957, *e.g.*, to produce in any material form, publish, perform, make adaptation, to make a copy of the work etc. Copyright Act provides protection against imitation of literary or artistic works which are the result of efforts, imaginative and intellectual creation. It is based on the right of the author, artist or composer to prevent another person from copying the original work. There is no copyright in ideas. It subsists only in the material form in which the ideas are translated - *Jefreys v. Boosey* [1854] 1 HLC 815. Copyright law protects the form and not the ideas. Ideas are not monopolised. They may take different forms or may be expressed differently. The form expressive of an idea is a mental abstraction. Copyright is not monopolistic in that. It does not prevent from creating the same product by bestowing skill, efforts and genius independently of the owner of the copyright.

Royalties, copyrights - Software Royalties, copyrights - Software

18.11-1 Consideration for transfer of computer software is royalties or business income or capital gains is debatable question. Computer software means a computer programme recorded on any disc, tape, perforated media or other information storage device. It is a programme which contains instructions to the computer. Software is usually developed in three stages. First, a systematic analyst or designer prepares a specification, which normally includes data flow diagrams setting out the basic logic of programme. Then a source code programme is written in either a higher level computer language (*e.g.*, Oacle, or Visual basic) for ease of development or lower level language (*e.g.*, C, C+, C++ or Visual C) for power explicit control output. However, in either case, the source code cannot be read directly by a computer. The source code is converted by an assembler or compiler programme into object code. Object code is essentially a form of source code which can be read or acted upon by microprocessor or central processor unit (CPU) of the computer. Object code is an expression in binary notation consisting of the series of ones and zeros, which (reflecting, electrically, "on" and "off" states) are understood by a particular computer. Object code, therefore, is a replication of source code in a different form—*International Business Machines Corporation v. Computer Imports Ltd.* [1989] 2 NZLR 395. Authorship of both the source code or the object code are protected by the Copyright Act, as literary work. Copyright protection is generally granted to computer generated works, *i.e.*, works generated by computer in the circumstances where there is no human author of the work.

In *Samsung Electronics Co. Ltd. v. ITO* [2005] [276 ITR 1](#) (AT), the Tribunal observed :

"A software may be described as a program or series of programs containing instructions for a computer required either for operational activities of the computer itself (ope-rational software) or for the accomplishment of other tasks (application software). Thus, in essence, software is a series of commands arranged in a structure (or a language) which the machine will understand and translate into the actions that are required to produce a result that could be communicated to the operator. There are basically two levels of computer languages. The computer program whether written in assembly language or high level language is known as the source code. This is the language with which all modern computer programmers are comfortable with and that is the higher level languages such as Visual C+ and other such programming languages in which the lines of codes are formulated in commonly understood English words. The statements in this language are referred to as source code. When the source code is translated by an assembler or a compiler into machine language, it is known as the object code and this is essentially a series of commands stung together in a language which is understandable by the programmer or the ope-rator on the one hand and which can be

translated into a language understandable by the computer on the other. Once developed, software programs are to be integrated with some hardware. Say for instance, the program developed is an application software program, it would have to be stored in the computer in such a manner so as to be integrated with the operating system. This result is formally achieved by actually recording all the components of the computer program on to a storage medium and which could be referred to by the computer, whenever a particular component is required. The program is then called upon by the operator by invoking a command or a series of commands. Once so called or invoked, the program will begin to issue all the instructions contained on the storage medium and process through the processing unit of the computer, all the various inputs and computation that are provided. Therefore, to summarise :

- (i) A software program is essentially a series of commands issued to the hardware of the computer that enables the computer to perform in a particular manner.
- (ii) The software program to be effective needs to be integrated with the hardware in such a manner so as to enable the series of commands to be initiated by the operator and in order that the computer can call upon any part of the series of commands at a given point of time.
- (iii) To render the foregoing phenomena the sequence of commands must be physically stored on a portion of the computer that can be readily accessed by the processing of the computer and as such the programs are, therefore, of a nature that they may be recorded on magnetic media such as a floppy drive or a hard drive.
- (iv) When computer software, be it of any type such as operation software, application software, etc., is procured, such type of software are recorded on CD ROM or floppy diskettes. In other words, the programs are recorded on these various types of media and then copies on to the hard disk of the computer, from where they can be accessed by the computer when called upon."

Software transfer - business, service or royalty income Software transfer - business, service or royalty income

18.11-1A Whether consideration involved in the transaction of a software is business or service income or royalty depends upon nature of the rights therein transferred. Predominant amongst them is whether the transferee has received not only the right to use the software in its business, but also the right to reproduce and redistribute the software to others. The rights transferred are :

1. Less than all the rights;
2. Outright alienation;
3. Mixture of 1 and 2 above.

Transaction in 1 above may yield business or royalty income, depending how the rights are transferred. It is business income when the transfer is made for the personal or business use of the acquirer, on terms which make the acquisition one of less than the full rights in the software. The owners still preserves copyright protection and restricts the acquirer's use of the software. It is a transfer of the copyrighted article rather than the copyright itself. It is royalty income when the payment is received for a partial transfer of rights. Such transaction involves granting of a licence to the other party to develop and market the software commercially, just as in the same manner as the author of a book grants rights to the publisher. However, if the transaction involves the disposition of the entire right such as an exclusive geographical licence for the useful life of the software, the income is not royalty, it is a sale of the copyright itself like sale of the copyright in a book. Such transactions involve outright alienation. The income is treated as commercial within article 7 or 14 or as of capital gain within Article 13. Thus, transfer of a software is a sale of product (transfer of a standard form) like copyrighted article; sale of copyright, or by way of grant of licence to develop and market commercially.

Software may be sold like manufactured products bundled in CD. Internet has made it possible to sell it as services. Many software majors (*e.g.*, IBM, Sun, Red Hat, Trend Micro) are now offering their products as services and asking consumers to pay service charges rather than one- time licence fees. Many other software vendors are experimenting with the concept of delivering "services" through internet and doing away with software installation at the consumer end and thus shifting from upfront licence revenue to long-term subscription. Companies are looking to access software functionality as a service with a usage-based pricing, which could be compared to the pricing of utilities and infrastructure services such as telecom, real estate or transport. IBM India has recently launched Software as Services (SaaS), which provides remote access to business software as service.

When the software payments are made under the mixed contracts (e.g., as a part of a packaged or bundled scheme of payments for computer operated machinery) then it would be necessary to break the payments into their constituent elements to be treated as royalty or business income or capital gains.

Royalties - Software and E-business Royalties - Software and E-business

18.11-2 As already discussed software is a literary works and copyright exists. It is not goods. It is an actionable claim. Therefore, the supply of the right to use the copyright in the software constitutes assignment of the actionable claim. The payment may be royalty or business income. Software cannot be physically performed. Electronic supply of the software is the supply of services and not goods. The payment for such supply cannot be taxed as royalty income because it is the payment made by the end user to acquire a product rather than to use the copyright over the product, in the same way as the payment is made for the purchase of a book. However, where a programme is kept confidential but is allowed to be used for a consideration by way of a contract, such consideration amounts to royalty income—*Advance Ruling P. No. 30 of 1999* [1999] [105 Taxman 240](#) (AAR - N. Delhi)

18.11-2a SOFTWARE - CO[BKMEND]PYRIGHTABLE ARTICLE OR COPYRIGHT - The courts have held that the software programme when put on a medium becomes goods, for the purpose of sales tax [see *Tata Consultancy Services v. State of Andhra Pradesh* [2004] [271 ITR 401](#) (SC)], or customs duty (see *Associated Cement Companies' Ltd. v. Commissioner of Customs* [2001] 4 SCC 593/124 STC 59)], because the expression "goods" has been defined in a wide term. Every kind of movable property is considered goods. The test for that purpose is not whether the property is tangible or intangible or incorporeal but whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed, etc. The question whether consideration for the use or the right to use of technology or knowledge or copyright in respect of an intellectual property, as represented on a floppy, CD-ROMs, punch cards, magnetic tapes etc. constitutes royalty income or income from the sales of goods depends on how the concerned statute treats such consideration and defines the subject-matter of charge viz. , "royalties", "goods" :-

- Sales Tax Act defines "goods", *inter alia*, to mean all kinds of movable property other than actionable claims, stocks, shares, and securities;
- Customs Act defines, *inter alia*, "goods" as any kind of movable property;
- Income-tax Act defines "royalty" as consideration for the use of or the right to use any copyright in literary works, any patent, trade mark, design or model, plan, secret formula, or industrial, commercial or scientific equipment etc.

For the purposes of sales tax, information, technology or the knowledge constitutes goods if scribed on a media. The Supreme Court in *Tata Consultancy Service v. State of Andhra Pradesh* [2004] [271 ITR 401](#) held :

"The term "goods" for the purposes of sales tax, cannot be given a narrow meaning. properties which are capable of being abstracted, consumed and used and/or transmitted, transferred, delivered, stored or possessed, etc., are "goods" for the purpose of sales tax. The test to ascertain whether a property is "goods" for the purposes of sales tax is not whether the property is tangible or intangible or incorporeal. The test is whether the concerned item is capable of abstraction, consumption and use and whether it can be transmitted, transferred, delivered, stored, possessed, etc. In the case of software, both canned and uncanned, all of these are possible. Intellectual property when it is put on a media becomes goods." (head notes)

As for customs duty, the Supreme Court observed as follows in *Associated Cement Companies Ltd. v. CC* [2001] 4 SCC 593/124 STC 59:

"Any media whether in the form of books or computer discs or cassettes which contain information technology or ideas would necessarily be graded as goods under the aforesaid provisions of the Customs Act. These items are movable goods and would be covered by section 2(22)(e) of the Customs Act.

It is true that what the appellants had wanted was technical advice on information technology. Payment was to be made for this intangible asset. But the moment the information or the advice is put on a media, whether paper or diskettes or any other thing, then what is supplied becomes a chattel. It is in respect of the drawings, designs, etc., which are received that payment is made to the foreign collaborators. It is these papers or diskettes, etc., containing the technological advice, which are paid for and used. The foreign collaborators part

with them in lieu of money. It is, therefore, sold by them as chattel for use by the Indian importer. The drawings, designs, manuals, etc., so received, are goods on which customs duty could be levied."

What is taxed under the Sales Tax Act is an article transferred for a consideration or under the Customs Act, having value irrespective of what it consists or contains. Such an article is a chattel which may be a paper or a diskette containing the technological advice, the drawings, designs, manuals, etc. The constituents or contents or their quality are of no relevance. But the Income-tax Act is concerned with the contents or the quality and the use or the right to use. The distinction between the contents and the chattel was pointed out by the Supreme Court (Associated Cements) as

"The decision of *Winter v. Putnam* 938 F.2d 1033(9ty Cir.1991) is also of no help to the appellants as in that case it was the quality of information regarding mushrooms which was not regarded as a product even though the encyclopaedia containing the information was regarded as goods. Here we are not concerned with the quality of information given to the appellants. The question is whether the papers or diskettes, etc. containing advice and/ or information are goods for the purpose of the customs Act, the answer, in our view, is in the affirmative."

What is being taxed under the Customs Act not the intellectual input but the goods whose value has been enhanced by the said input. The final product at the time of import is either the magazine or the encyclopaedia or the engineering drawings as the case may be, and there is no scope for splitting the engineering drawing or the encyclopaedia into intellectual input on the one hand and the paper on which it is scribed on the other. For example, paintings are also taxed under the Customs Act. Valuable paintings are worth millions. A painting or a portrait may be specifically commissioned or an article may be tailor-made. This aspect is irrelevant since what is taxed is the final product and not the cost of the canvas and the oil paint even though the composite product, *i.e.*, the painting is worth millions (*see Associated Cement Companies Ltd. v. CC* [2001] 4 SCC 593).

The focus of Customs Act or the Sales tax Act is not on the intellectual input but on the final product, *i.e.*, the paper or the diskettes containing technological advice, or drawings, designs or manuals, etc, as being goods, while of the Income tax Act not on paper or diskette as such but on the technological advice etc. and the transfer of the rights in respect thereof. The distinction is well brought about the court in *St. Albans City and District Council v. International Computers Ltd.* [1996] 4 All ER 481, "Clearly, a disk is within the definition. Equally clearly, a program, of itself, is not" The disc is goods for the purposes of Customs Act or the Sales tax Act, but not the intellectual input, of itself, even though such input enhances its value or sale consideration. The comparison with the sale of book of video cassette may be valid so far as the Sales of Goods or the Customs Act is concerned but not when the matter relates to the protection of the copyright of the intellectual component of the software and income attributable to it. There is, thus, a difference between purchase of a book, music cassette/video or film and purchase of software. When one buys a video cassette, a book, sheet music or a musical recording, one acquires a limited right to use and enjoy the materials content. One does not acquire, however, all that the owner has to sell. These additional incidents of ownership include—

- the right to produce and sell more copies;
- the right to change the underlying work;
- the right to license its use to other; and
- the right to transfer the copyright itself.

These incidents of the intellectual, intangible component of the software property cannot be linked with the tangible medium in which the software is stored and transmitted and taken as tangible property.

There, therefore, a distinction lies between the copyrightable article and the copyright itself.

The machine readable language or code is the physical manifestation of the information in binary form. It has been noticed that at least three program copies exist in a software transaction (i) an original, (ii) a duplicate, and (iii) the buyer's final copy on a memory device. It has been noticed that the program is developed in the seller's computer then the seller duplicates the program copy on software and transports the duplicates to the buyer's computer. The duplicate is read into the buyer's computer and copied on a memory device. It has been held :

- that the software is not merely knowledge, but rather knowledge is recorded in a physical form having a physical existence, taking up space on a tape, disc or hard drive, making physical things happen and can be perceived by the senses;

- that the purchaser does not receive mere knowledge but receives an arrangement of matter which makes his or her computer perform a desired function;
- that the arrangement of matter recorded on tangible medium constitutes a corporeal body;
- that a software recorded in a physical form becomes inextricably intertwined with, or part and parcel of the corporeal object upon which it is recorded, be that a disc, tape, hard drive, or other device;
- that the fact that the information can be transferred and then physically recorded on another medium does not make computer software any different from any other tape of recorded information that can be transferred to another medium such as film, video tapes, audio tapes or books;
- that by sale of the software programme the incorporeal right to the software is not transferred;
- that incorporeal right to software is the copyright which remains with the originator. What is sold is a copy of the software;
- that the original copyright version is not the one which operates the computer of the customer but the physical copy of that software has been transferred to the buyer;
- that when one buys a copy of a copyrighted novel in a bookstore or a recording of a copyrighted song in a record store, one only acquires ownership of that particular copy of the novel or song but not the intellectual property in the novel or song.

The Appellate Tribunal in *Samsung Electronics Co. Ltd. v. ITO* [2005] [276 ITR 1](#) (AT) held:

"Right to use of a copyright is totally different from the right to use the programme embedded in the cassette or CD or it may be software."

In this case, the assessee had acquired a ready made-off-the-shelf computer programme for being used in its business. No right was granted to the assessee to utilize the copyright of the computer programme. The assessee had merely purchased a copy of the copyrighted article, namely, a computer programme which is called a 'software'. Looking at the circumstances of the case and considering the facts that the definition of 'royalty' as provided in the treaties does not apply to the facts of the case"

Thus, there is distinction between the transfer of a copyright in the computer programme and transfer of a copy of the computer programme (copyrighted article). In the former case, the recipient user has the right to copy the software for distribution to the public and/or the user has the right to use the code in derivative programmes created by the user. The revenue from such transfer will be treated as sales or royalty income depending on whether the user receives substantially all the rights in the copyright (or at least all of such rights for a specific geographic area) or more limited right non-exclusive right in the software. In the latter case, the user has no right to duplicate the software for the third party or use source code to create derivative software. The transfer may result in revenue from the sale of a product or lease revenue.

18.11-2b SOFTWARE - CUSTOMIZED OR [BKMEND]NON-CUSTOMIZED- ESSENCE OR PURPOSE OF THE TRANSACTION TEST - Computer program is the product of an intellectual process and is copyrightable as intellectual property. But once implanted in a medium, they are widely distributed to computer owners. An analogy can be drawn to a compact disc recording of an orchestral rendition. The music is produced by the artistry of musicians and in itself is not "goods", but when transferred to a laser-readable disc becomes a readily merchantable commodity (*see Advent Systems Ltd. v. Unisys Corp* (925 F.2D 670 (3rd. Cir. 1991) A disc or tape containing a program is tangible in character, though its content is the reproduction of the product of an intellectual effort. The disc or the tape for wide distribution is a copyrighted article, while its content is copyrightable intellectual property. The Supreme Court of Ohio in *Interactive Information Systems, Inc. v. Limbach* [1985] 18 Ohio St. 3d 309; 480 N.E. 2d 1124, distinguished that tapes were tangible, while computer information was intangible. The courts that have found that computer software to be tangible have based their decisions on the fact that the computer program was coded on a tangible medium, such as computer tape (*see Citizens and Southern Systems, Inc. v. South Carolina Tax Commissioner* [1984] 280 S. C. 138; 311 S.E. 2d 717) and *Comptroller of the Treasury v. Equitable Trust Co.* [1983] 296 Md. 459; 464A 2d 248 (finding that only noncustomised computer software is tangible property)]. But the essence of the transaction in the sale of computer software is the purchase of intangible information (*Compuserve Inc. v. Lindley* (535 N. E. 2d 360) The essence- or- purpose-of-the-transaction test is to be applied to determine whether the software is tangible or intangible property. In a non-customised software, the purchaser

neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function.

In *St. Albans City and District Council v. International Computers* [1996] 4 All ER 481, it was observed :

"During the course of hearing, the word 'software' was used to include both the (tangible) disk onto which the COMCIS program had been recorded and the (intangible) program itself. In order to answer the question, however, it is necessary to distinguish between the program and the disk carrying the program.

In both the Sales of Goods Act, 1979, section 61, and the supply of Goods and Services Act, 1982, section 18, the definition of goods includes 'all personal chattels other than things in action and money'. Clearly, a disk is within this definition equally clearly, a program, of itself, is not."

As regards utility of an instruction manual, it was observed:

"As I have already said, the program itself is not "goods" within the statutory definition. Thus a manual of the program in the way I have described does not, in my view, constitute a transfer of goods. It follows that in such circumstances there is no statutory implication of terms as to quality or fitness for purpose."

A software program is the creation of an intellectual effort. It has been held by the American Courts in *Commerce Union Bank v. Tidwell* (538 S.W. 2d 405); *State of Alabama v. Central Computer Service Inc.* (349 So. 2d 1156); *First National Bank of Fort Worth v. Bob Bullock* (584 S.W. 2d 548); *First National Bank of Springfield v. Department of Revenue* (421 NE 2d 175); *Compuserve Inc. v. Lindley* (535 N.E. 2d 360) and *North East Datacom Inc. et al v. City of Willingford* (563 A 2d 688)—

- that by sale of the software programme the incorporeal right to the software is not transferred;
- that incorporeal right to software is the copyright which remains with the originator. What is sold is a copy of the software;
- that the original copyright version is not the one which operates the computer of the customer but the physical copy of that software has been transferred to the buyer;
- that when one buys a copy of a copyrighted novel in a bookstore or a recording of a copyrighted song in a record store, one only acquires ownership of that particular copy of the novel or song but not the intellectual property in the novel or song.

The information contained in the software program can be introduced in the user's computer by several different methods, namely, (a) it could be programmed manually by the originator of the program at the location of the user's computer, working on his own instructions; or (b) it could be programmed by a remote programming terminal loaded miles away from the user's computer, with the input information, with the input information being transmitted by telephone; or (c) more commonly the computer could be programmed by use of punch cards, magnetic tapes or discs, containing the program developed by the vendor. Vendor also provides manuals, services, and consultation designed to instruct the use's employees in the installation and utilization of the supplied program. The American courts (*Commerce Union Bank v. Tidwell* (538 S.W. 2d 405); *State of Alabama v. Central Computer Service Inc.* (349 So. 2d 1156); *First National Bank of Fort Worth v. Bob Bullock* (584 S.W. 2d 548); *First National Bank of Springfield v. Department of Revenue* (421 NE 2d 175); *Compuserve Inc. v. Lindley* (535 N.E. 2d 360) and *North East Datacom Inc. et al v. City of Willingford* (563 A 2d 688)] held:

- that even though the intellectual process is embodied in a tangible and physical manner, that is on punch cards, magnetic tapes etc., the logic or intelligence of the program remains intangible property;
- that it is this intangible property right which is acquired when computer software is purchased or leased;
 - that what is created and sold is information and the magnetic tapes or the discs are only the means of transmitting these intellectual creations from the originator to the user;
 - that the same information could have been transmitted from the originator to the user by way of telephone lines or fed directly into the user's computer by the originator of the program and that as there would be no tax in those cases merely because the method of transmission is by means of a tape or disc, it does not constitute purchase of tangible personal property and the same remain intangible personal property;
 - that what the customer paid for is the intangible knowledge which cannot be subjected to the personal property tax;

The American courts [*South Central Bell Telephone Co. v. Sidney J. Barthelemy* (643 So. 2d 1240); *Comptroller of the Treasury v. Equitable Trust Company* (464 A.2d 248); *Chittenden Trust Co. v. Commissioner of Taxes* (464 A.2d 1100); *University Computing Company v. Commissioner of Revenue for the State of Tennessee* (677 S.W. 2d 445) and *Hasbro Industries, Inc. John H. Norberg, Tax Administrator* (487 A.2d 124)], held that when stored on magnetic tape, disc or computer chip, the software or set of instructions is physically manifested in machine readable form by arranging electrons,

Royalties - E-commerce transactions - Software know-how or services - TAG recommendatory

18.11-3 To distinguish payments for services and payments for know-how as regards e-commerce transactions related to computer software programme, the Technical Advisory Group (the TAG) pointed to the "Software regulations" which the U. S. IRS and Treasury issued in 1998 regarding the characterisation of income from cross-border transactions involving computer programmes, as providing useful criteria. These regulations deal with the distinction between the provision of services (for the development or modification of the computer programme) and the provision of know-how (relating to computer programming technique) in the following words :—

Provision of services :- The determination of whether a transaction involving a newly developed or modified computer programme is treated as either the provision of services or another transaction described (above) is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer programme and how the risks or losses are allocated between the parties.

Provision of know-how :- The provision of information with respect to a computer programme will be treated as provision of know-how only if the information is :

- (1) Information relating to computer programming techniques;
- (2) Furnished under conditions preventing unauthorised disclosure, specially contracted or between the parties; and
- (3) Considered property subject to trade secret protection.

Example.....

(i) Facts. Corp. A, a U.S corporation, and Corp. I, a Country Z corporation, agree that a development engineer employed by Corp. A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp. I to more efficiently create computer programmes. These techniques represent the product of experience gained by Corp. A from working on many computer programming projects, and are furnished to Corp. I under non-disclosure conditions. Such information is property to trade secret protection.

(ii) Analysis. The transaction contains the elements of know-how specified (above). Therefore, this transaction will be treated as the provision of know- how".

Royalties - Consideration for the use or the right to use

18.12 What is taxed as royalties is the amount received as a consideration for the use or the right to use, and not outright purchase of the right to use an asset. Royalty is thus a consideration, including a lump sum consideration, for the transfer of all or any right (including the granting of a licence) in respect of a copyright, patent, trade mark, design and model, or secret formula etc.

Any right in respect of a patented invention can be conferred because a patent is a bundle of rights which may be divided and assigned, or restrained in whole or in parts. If the entire patent itself, an undivided part or share of the entire patent, or all rights under a patent in a specified geographical region has been conveyed, it would be an assignment [see *Waterman v. Mackenzie* 138 US 252 (1891)]. But when the right to use has been given, it would be licence. Right in respect of the patented invention is not the right in the patented invention. The two transfers are different and have different legal effects. In one only right to use has been granted, the ownership remained with the patentee; while in the other, the ownership of that right has been conveyed. The expression "in respect of" conveys that an act is said to have been done in respect of something if it has relation or reference to that something. It is used to mean "in connection with", implying nexus between the two. The Supreme Court in *Hindustan Lever Ltd. v. CIT* [1999] [239 ITR 297](#) in the context of taxability of income, observed that interest

payable by statute on rent in arrears is not payment of rent, not a part of the payment, nor is it an accretion to it, though it is received in respect of it. Similarly, conferment of any right in respect of the patented invention is not the transfer of ownership but conferment of the right in respect thereof.

Transfer of the "right in the property" is not the subject-matter. It is the transfer of the "right in respect of the property". The two transfers are distinct and have different legal effects. In one rights are purchased (which enable use of those rights), while in the other, no purchase is involved, only right to use has been granted. Ownership denotes the relationship between a person and an object forming the subject-matter of his ownership. It consists of a complex of rights, all of which are rights in rem, being good against all the world and not merely against a specific person and such rights are indeterminate in duration and residuary in character—*Swadeshi Ranjan Sinha v. Hardev Banerjee* AIR 1992 SC 1590, and *Sukumari Debi v. Ramdas Ganguli* AIR 1994 Cal. 85. When rights in respect of a property are transferred and not the rights in the property, there is no transfer of the rights in rem which may be good against the world but not against the transferor. In that case the transferee does not have the rights which are indeterminate in duration and residuary in character. Lump sum consideration is not decisive of the matter. That sum may be agreed for the transfer of some two rights but not the ownership. Thus, the definition in respect of the copyright, patent etc., does not extend to the outright purchase of the right to use an asset. A payment for the absolute assignment and ownership of rights transferred is not a payment for the use of something belonging to another party and, therefore, not royalty - *D.B. Group Ltd. v. CIR*; *DGB Production Ltd. v. CIR* [1996] 17 NZTC 12,446. In an outright transfer to be treated as sale of property as opposed to licence, alienation of all rights in the property is necessary. It is also so treated, if the alienation is of all rights to a geographical area or to a particular field of use, or if the right to use will last for the substantial portion of the economic life of the property.

Transfer of property or right in respect thereof Transfer of property or right in respect thereof

18.12-1 To determine whether a patent transfer agreement conveys all substantial rights under a patent to a transferee or fewer than all those rights, the court must assess the substance of the rights transferred and the intention of the parties involved. In making such a determination, it is helpful to consider rights retained by the grantor in addition to rights transferred to the grantee. (*see Vaupel v. Meccanica Euro Italia S.P.S* 944 F.2d 870; 20 USPQ 2d 1045 (Fed. Cir 1991). A grant of all substantial rights in a patent amounts to an assignment - that is, a transfer of title in the patent - which confers legal standing on the assignee to sue another for patent infringement in its own name (*see Waterman v. Mackenzie* 138 US 252 (1891); *Ortho Pharm. Corp. v. Genetics Inst. Inc.* 52 F.3d 1026; 34 USPQ 2d 1444 (Fed. Cir. 1995). Conversely a non- exclusive license or a bare license (a covenant by the patent owner not to sue the licensee for working the license and under which the patent owner reserves the right to grant similar licenses to other entities) confers no legal standing on the licensee to bring a suit or even to join a suit with the patentee because a non-exclusive or bare licensee suffers no legal injury from the infringement (*see Rite - Hite Corp. v. Kelley Co. Inc.* 56 F.3d 1538) An exclusive licensee receives more substantial rights in a patent than a non-exclusive licensee, but receives fewer rights than an assignee of all substantial patent rights. For example, an exclusive licensee could receive the exclusive right to practice an invention within the given limited territory. A licensee right to sub-lease is an important consideration in evaluating whether a license agreement transfers all substantial rights.

Royalties - Consideration for the use - Indian Law Royalties - Consideration for the use - Indian Law

18.12A Section 9 of the Indian Income-tax Act, 1961, defines the term "royalty" as "consideration for" -

- transfer of rights "in respect of" technology or of copyright;
- use of technology;
- use or right to use industrial, commercial or scientific equipment;
- imparting of information concerning for the working of, or use of, technology; or concerning technical, industrial, commercial or scientific knowledge;
- rendering services in connection with the activities in connection with the above, *i.e.*, the activities for the "use" or "right to use" or "in respect of" technology or copyright.

The important feature is that the payment is a "consideration for" transfer "in respect of" or the "use" or "right to use" of technology or the copyright. The identification of the consideration of payment is, therefore, necessary to determine whether it is royalty. It is so taken, if it is "in respect of" or the use or the "right to use". These

expressions convey that the property itself has not been transferred. A payment for the absolute assignment and ownership of rights is not a payment for the use of something belonging to another (*see* preceding paragraph). The matter is further discussed in paragraph 18.16.

Royalties - Equipment royalty - Consideration for the use or the right to use - E-commerce - Digital products

18.12A-1 Royalty has been defined as a consideration *inter alia*, for-

- imparting knowledge or
- use or right to use equipment,

which is capable of industrial, commercial or scientific application and use for the production of an end result; former being an experience, special knowledge and skill and the latter a tool, necessary for the industrial or commercial production of a product. Both have technical and intellectual contents. Special knowledge and skill (know-how) may ripen into a form of property in the fields of commerce and industry as in copyright, design or patent, which is parted with for a consideration. Similar is the case with equipment which are necessary for production of a result. Equipment means necessary tools for a particular purpose. It also means the process of equipping or being equipped, *i.e.*, supplying what is needed. Equipment, therefore, means a set of tools for or the process of supplying what is required for producing or manufacturing the end product. The word "equipment", in the context of definition of royalties, applies to property that is intended to be an accessory in an industrial, commercial or scientific process. It could not be applied to property, such as a music or video CD that is used in and for itself.

A patent is an invention which involves the manner of manufacture, machine by which manufacturing is done or the substance produced as a result of manufacturing. Manufacturing involves making a product, using a process, exercising an operating mechanism and selling the end product. A patent is a monopoly right to "make, use, exercise or sell", which expression comprehends the manner of exploitation appropriate to all manners of manufacture; if a product can be made, if a process can be used, if an operating mechanism it can be exercised to secure the promised result, and whenever there is an end product, that can be sold (*see Pfizer Corporation v. Ministry of Health* [1963] RPC 173). Process of manufacture and product of manufacture are two independent subject-matters. The equipment is concerned with the process of manufacture. A process is a mode of treatment of certain materials to produce a given result. It is an act, or series of acts, performed upon a subject-matter to be transformed and reduced to a different state of thing. "If one of the steps of a process be that a certain substance is to be reduced to a powder, it may not at all material what instruments or machinery is to be used to effect that object, whether the hammer, a pestle or mortar, or a mill. Either may be pointed out, but if the patent is not confined to that particular tool or machine, the use of the others would be infringement, the general process being the same." (*see Cochrane v. Deener* 94 US 780). A particular tool or machine or an equipment used in the process may have intellectual and technical content and is taken property in the fields of industry and commerce as in copyright or patent which is parted with for a consideration.

The equipment may represent technology, *i.e.*, practical application of knowledge. Technology is a manner of accomplishing task especially using technical process, methods, or knowledge, *i.e.*, the totality of the means employed to provide objects necessary for human sustenance and comfort

Payments made for the use or the right to use of industrial, commercial or scientific equipment are taken as royalty income if the user has, and as services income if he has no, possession and control over it. When in possession and control, the user has the economic and possessory interest and bears the risk of its non-performance. For example, payments made by a customer to host his website on a server, cannot be taken as royalty income as the customer does not have the control over or possession of the server. It is owned and maintained by its owner, who is in the business of providing such service and collects such payments as his income in the course of his business. The Madras High Court in *Skycell Communications Ltd. v. DCIT* [2001] [251 ITR 53](#) held that installation and operation of sophisticated technical equipment with a view to earn income by allowing customers to avail of the benefit of the user of such equipment does not result in the provision of technical services to the customer for a fee. It was further held that collection of a 'fee' for use of a standard facility provided to all those willing to pay for it does not amount to the fee having been received for technical services. When a person decides to subscribe to a cellular telephone service in order to have the facility of being able to communicate with others, he does not contract to receive a technical service. What he does agree to is to pay for the use of the airtime for which he pays a charge.

The fact that the telephone service provider has installed sophisticated technical equipment in the exchange to ensure connectivity to its subscriber, does not on that score, make it provision of a technical service to the subscribers. What applies to a cellular mobile telephone service is also applicable in a fixed telephone service. Neither service can be regarded as "technical service".

Payments for time-limited use of software and other digital information licences may not be considered as payments for the use of, or the right to use, industrial, commercial or scientific equipment. Limited duration right means when the customer receives it for a period of time that is less than the useful life of the product. The product is either downloaded electronically or delivered in a tangible medium such as CD. All copies of the digital product are deleted or become unusable upon termination of licence. They cannot be considered payments for the "use, or the right to use" the product because these words do not apply to payments made to definitively acquire a property designed to have a short useful life and also because the digital products cannot be

- ◆ considered equipment, or
- ◆ viewed as "industrial, commercial or scientific".

However, payments for the use of the tangible computer equipment (hardware) could be considered as payment for the use of, or the right to use, industrial, commercial or scientific equipment, under certain circumstances. The TAG formulated the following factors for determining whether the payments are for the use of, or the right to use, industrial, commercial or scientific equipment :—

- ◆ the customer is in the physical possession of the property or controls or has a significant economic or possessory interest in it,
- ◆ the provider does not bear any risk of substantially diminished receipts or increased expenditure in case of non-performance or does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
- ◆ the total payment does not substantially exceed the rental value of the computer equipment for the contract period.

Some of these factors may not be relevant in particular cases. All relevant facts bearing on the substance of the transaction should be taken into account when determining the agreement is a service agreement or a lease.

Applying these factors to application service provider transactions, the TAG concluded that these should generally give rise to services income as opposed to rental payments. In a typical transaction, the service provider uses the software to provide services to customers, maintains the software as needed, owns the equipment on which the software is loaded, provides access to many customers to the same equipment, and has the right to update and replace the software at will. The customer may not have possession or control over the software or the equipment, will access the software concurrently with other customers, and may pay a fee based on the volume of transactions processed by the software.

Likewise, data warehousing transactions should be treated as service transactions. The vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment and has the right to remove and replace the equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

Royalties - Use or right to use and sale, distinctionRoyalties - Use or right to use and sale, distinction

18.13 Royalty has been defined as the consideration for the use or the right to use of, *inter alia*, industrial, commercial or scientific equipment. Such a right is imparted as a part of technology transfer, or sometimes as part of business activity of leasing of machinery or equipment, or is granted for such time till the transaction ripens into sale. A distinction has, therefore, to be made between the consideration paid for the use of equipment, whether it could be taken royalty under article 12, or business income under article 7, or capital gains under article 13, or professional income under article 14, or other income under article 21.

Normally technology could be had through package deals which include comprehensive transfer of equipment, industrial properties like patents and trade marks, skill, etc. Transfer and dissemination takes place through collaborations, joint ventures, turnkey projects, purchase of machineries, sale of technologies, hiring of expertise. The collaboration agreements are of two types; (1) licensing arrangements (2) transfer of skills, experience and know-ledge. The first relates to permitting the use of patents and trade marks; and the second to transfer of

experience and skills such as service and engineering agreements. In practice, these are not mutually exclusive. A licensing agreement may also include technical assistance. A technical assistance may include right to use trade marks. In rendering technical assistance, the aid of machinery or equipment is necessary, and therefore, agreement includes licensing of such machinery or equipment. The consideration received for such licensing is taken to be 'royalty' income. If equipment is given on hire by a person in the normal course of business, the consideration received is taken as business income - *CEPT v. Shri Lakshmi Silk Mills Ltd.* [1951] [20 ITR 451](#) (SC).

When an equipment has been leased for a consideration, the lessor retains the ownership of an asset but conveys the right to use it to the lessee for an agreed period of time in return for the payment of specified rentals. A lease consists of a right to the possession and the use of the property owned by some other person. It is an outcome of the separation of ownership and possession - *A.R. Krishnamurthy & A.R. Rajagopalan v. CIT* [1982] [133 ITR 922](#) (Mad.). Thus the basic characteristic of the concept of leasing is the divorce between 'ownership' and 'use' of the asset. But some contracts contain hire element and the sale element, as in the hire-purchase agreement. It is the nature of a contract of bailment with an element of sale added to it. It, however, differs from sale transaction. In a sale where price is payable by instalments, property nonetheless passes on the date of the contract, while in a hire-purchase agreement, it passes when the option is finally exercised by the intending purchaser after complying with all terms of the agreement. Hire-purchase contract is often used to describe contract which are in reality agreements to purchase chattels by instalments, subject to the condition that the property in them is not to pass until instalments have been paid. *Halsbury's Laws of England*. The hire-purchase agreement contract fixes the total amount payable by the hirer-cum-purchaser which exceeds the original price of the asset by an amount which may be called hire charges. Thus instalments paid by the purchaser/hirer do not in principle constitute royalties and the gain is taxable as capital gains under article 13. In the case of landless, and leasing in particular, the principal purpose of contract is normally that of hire, even if the hirer ultimately exercises an option to purchase it. Article 12, therefore, applies in the normal case to the rentals paid by the hirer, including all rentals paid by him upto the date he exercises any right to purchase. Model Double Taxation Convention on Income and on Capital, OECD 1977. The model has now been amended. The income is taken as business income as per the amended model.

The OECD Model Tax Convention does not distinguish between payments for the provision of services and payments for the sale or rental of property, which fall under article 7 (business income). The basic difference, however, is whether the customer acquires a property from the provider. The term "property", according to the Technical Advisory Group of the OECD, includes property which typically is carried on a tangible medium but may be transferred from medium to medium such as electronic data, a software programme copy, digitalised music or video images, and other forms of digital information and contents. The basic distinction between a service transaction and goods transaction is whether the customer acquires property from the vendor. A transaction is treated as a service transaction if the ownership of the property is not transferred. If a customer engages the vendor to create an item of property that the customer will own from the moment of its creation, then no property will have been transferred from the vendor to the customer. The transaction is the transaction of service. It is irrespective of the vendor having made use of his own property and having it transferred in the process of providing services, so long as the predominant nature of the transaction is not the transfer of that property but the provision of service. This happens when the property itself has little intrinsic value and the vendor creates value through the exercise of its particular talents and skills to create a unique result for the customer.

In the know-how contract, generally one of the parties agree to impart to the other, his special knowledge or experience, so that the other can use it for his own account. The grantor is not required to play any part himself in the application of the formula granted. This differs from contracts for the provision of services, in which one of the parties undertakes to use his skills and expertise to execute work himself for the other party. Such participation is ensured through many ways.

There are a number of modes open to business organisations to pool their resources. These are :

- ◆ Franchising
- ◆ Licensing
- ◆ Sale of turnkey plants
- ◆ Co-production agreements
- ◆ Joint ventures

Royalties, right to use - Franchising Royalties, right to use - Franchising

18.13-1 In franchising, the ownership of enterprise remains with the supplier of the patent. There is a privilege granted by the owners of the technology to an individual or a corporation by which the grant is permitted to operate a business under certain conditions. It means granting of an exclusive right to another corporation. The features of franchise are :

- ◆ Duration of the issue
- ◆ Rates charged for services
- ◆ Services to be conducted
- ◆ Capitalization.

In return the grantee companies generally agree to pay a fixed percentage of the gross sale. The ownership of the enterprise remains with the corporation and all taxes are borne by its owner. Management is conducted locally with the experts from the foreign companies available on request and on fee.

Royalties, right to use - Licence Royalties, right to use - Licence

18.13-2 In a licensing agreement, the arrangement usually entails a form with sophisticated technical expertise in a specific industry, which sells package of technology to another for consideration.

Royalties, right to use - Turnkey plants Royalties, right to use - Turnkey plants

18.13-3 In turnkey plants the foreign companies provide machinery, supervising the assembling of production line for the product which it has licensed, besides offering expertise to the host company.

Turnkey contracts combine the provision of tangible assets, such as machinery, with technical services, training and communication of knowledge forming the technical know-how, or technical assistance provided up to the completion of the work, as well as securing resources to acquire all types of property outside the country.

Royalties, right to use - Co-production agreement Royalties, right to use - Co-production agreement

18.13-4 In co-production agreements, there is a joint manufacturing of a product generally for an extended period of time. One partner usually supplies components to be integrated into the equipment produced by the other partner. The final product then is marketed by both the parties in and outside the respective home States. Occasionally this form of corporation combines both the licensing agreements and the turnkey plant sale.

Royalties, right to use - Joint ventures Royalties, right to use - Joint ventures

18.13-5 As association of individuals or firms formed to carry out a specific business project although a joint venture is very similar to the partnership. It differs in that it is limited to the success or failure of the specific project for which it is formed. As in the case of partnership, a joint venture is formed by a contract agreement in which each partner assumes unlimited liability for the organisation debts.

Royalties, right to use - Partly business and partly royalties Royalties, right to use - Partly business and partly royalties

18.13-6 Income arising as a result of co-production agreements or joint ventures is essentially income from business, and the one arising from franchising, licensing, turnkey projects is partly business and partly royalty. The payments obtained as consideration for after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, for professional services given by a professional such as an engineer, and advocate, or an accountant, do not constitute royalty. Such income generally falls under article 7 or 14. The cases where the contracts are of mixed nature, consisting of imparting technical know-how and business venture, the appropriate course is to apportion the receipt between its components as to ascertain how much of it could be referable to technical know-how and how much to business or professional activity so that each component is appropriately dealt with under the respective article, unless where one component constitutes by far the principal purpose and other is only ancillary and largely unimportant character when the whole amount of the consideration is to be attributable to the principal part. If, however, income is of such a nature that it could fall equally under any of the articles, it should be covered under that article which specifically so provides in respect of that income.

An almost similar question arose before the Madras High Court, whether the amount received by a non-resident collaborator be taxed as an income arising or accruing in India by reason of business connection in India [in terms of section 9(1)(i)] or as the technical fee for services rendered [in terms of section 9(1)(vii)] in *CIT v. Copes Vulcan Inc.* [1987] [167 ITR 884](#) (Mad.). The court held that if the nature of income is such as it falls under a specific provision, it has to be taxed under that provision and not under the general provision.

Technology transfer - Classification of income Technology transfer - Classification of income

18.13-7 Discussion in the preceding paragraphs leads to the conclusion that classification of income derived from the supply of technology depends upon the nature of transaction of supply:

<i>Transaction</i>	<i>Classification</i>
1. Sale of rights to use technology (by way of absolute assignment)	Business income or capital Gains
2. License to use technology	Royalty
3. Technical service fees	Royalty or business income
4. Independent personal services	Business income.
5. Dependent personal services	Salary or wages.

There has always been characterization difficulty whether income from an electronic transaction be taken as royalty income as arising from the use or right to use a copyright, or as business income arising from providing services. Identification of the consideration for what is paid may decide; if done for a right other than the copyright (such as other types of contractual rights or such as data or services), it is not royalty. The use of copyright is incidental to the transaction of a purchase of a digital product for the own use or enjoyment of the acquirer, such as music, picture or movies or computer programs.

This is more relevant in case of use of software. Computer or the software is an "industrial, commercial or scientific" equipment.

The consideration for the use or the right to use it, whether royalty or service income, as already discussed, depends on—

- whether the user has physical possession of the property, control over it, economic and possessory interest in it,
- whether the provider does not bear the risk of substantially diminished receipts or increased expenditure if there is non-performance under the contract and also does not use the property concurrently to provide significant services to others,
- whether total payment does not substantially exceed the rental value of the computer equipment for the contracted period.

Their absence would mean service income and presence royalty income.

TAG of the OECD examined a few transactions where the issue could arise whether the words "payments for the use of, or the right to use, industrial, commercial or scientific equipment" could cover payments for the use of digital products or computer equipment. Of the 28 categories, in two cases it was held to be royalty income (category 3 and 19), in four cases it could be royalty/technical fees or business depending on the facts (category 12, 14, 18, 25), and in the remaining, business income. The tax treatment of the transactions depend on a question, for what the consideration is paid. Where the essential consideration is for something other than the use of, or the right to use, rights in the copyrights and the use of the copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, such use of copyright should be disregarded in the analysis of the character of the payment. The consideration if paid for a right other than the right in the intellectual property, is not to be treated as royalties as it is a purchase of for the purpose of use of the product. Payments for use of digital products cannot be considered payments for the use or the right to use industrial, commercial or scientific equipment and, thus, royalties. It is business income. It is immaterial whether the product is downloaded electronically or delivered on a tangible material. For example, payments made for electronic ordering of tangible product which is delivered to the customer by a common carrier or software or other digital product which is down-loaded (delivered) to the customer's hard disk (if for purposes of copyright exploitation, royalty income), including updates and add ones; or right to use software or other digital product for a period of time less than the useful life of the product, either downloaded electronically or delivered on a tangible medium

such as CD; or right to use one time (with no right to make copies), either downloaded or used remotely (e.g., use of software stored on a remote server); or allowing a user to have access, execute and operate the software application hosted on a server owned by the host and customers utilizing the equipment concurrently, having no possession or control over the computer equipment, the application having been executed either at the customer's computer after it is downloaded into RAM or remotely on the host's server; or application service provider making available to customers access to a software application hosted on a computer server owned and operated by the provider, customer having no right to copy the software or to use software other than on the provider's server, and having no possession or control of a software copy; or provider offering space on its server to host website for a fee based on the passage of time, having no rights in the copyright created by the developer of the website contents; or software maintaining and updates; or provider owning and operating a server and allowing it for a customer to store computer and to have access upload and manipulate data remotely or making a repository of the information available for customers to search and retrieve. These are few illustrations of the payments having been received as consideration not for any right in respect of the intellectual property.

The consideration if paid for transfer of any right in respect of copyright, patent or secret formula or any other type of intellectual property, is treated as royalties; for example, electronic ordering and downloading of digital products for the purpose of copyright exploitation or providing to the customer with undivulged technical information concerning a product or process.

There is a grey area between the two types of considerations. It could be treated business profits or royalties/fees for technical services, depending on the facts and circumstances of each case; for example, fee for software maintenance; customer support over computer software; electronic access to professional advice; payments made by a website operator to content providers for news stories, information and other online content in order to attract users to site.

Royalties - Permanent establishmentRoyalties - Permanent establishment

18.14 Paragraphs 4 and 5 of article 12 are exceptions to the rules contained in paragraphs 1 and 2. The provisions are similar to those as found in article 10 and article 11. Where royalties arise through assets which are owned by permanent establishment or fixed base or where the person paying the royalty has a permanent establishment or the fixed base in connection with which liability to pay royalty is incurred and the liability is borne by such establishment or the base *i.e.*, the royalties are directly connected with permanent establishment or the fixed base even one belonging to the enterprise of the third country, they are taxable as business income. The payment is not assessable as royalty or technical fee but assessable as business income under article 7 if :—

- i. The beneficial owner carries on a business through PE;
- ii. The payments in question arise in the course of such business;
- iii. The payments are effectively connected with such PE.

Thus, in case the business is carried on through PE, it is article 7 and not article 12, that is operative to bring to tax all receipts arising in the course of business; whether it is in the nature of royalty, dividends or interest - *Advance Ruling P. No. 28 of 1999* [1999] [105 Taxman 218](#) (AAR - N. Delhi), [2000] 242 ITR 208.

Royalties Permanent establishment - Advance Ruling Case - AAR No. P. 13 of 1995 Royalties Permanent establishment - Advance Ruling Case - AAR No. P. 13 of 1995

18.14-1 The authority for Advance Ruling considered a situation - *AAR No. P-13 of 1995, In re*, decided on 23rd August, 1995 [1997] [94 Taxman 171](#) (AAR) where a person who is not resident of India but has a PE in India in connection with which it proposes or expects to enter the contracts under which it would have to pay royalties and fees for technical services. The Authority held in para 20 of the Ruling, "This circumstance that the royalties or the fees for technical services are paid in respect of information or services put to use in India is sufficient, under section 9(1)(vi) and (vii) of the Act (Indian Income-tax Act, 1961), to consider them as accruing or arising in India. But para (7) of article 13 of the DTA (Indian Tax Treaty with France) requires the fulfilment of a further condition before such royalties and fees for technical services can be deemed to arise in India where it has a permanent establishment, *viz.*, that the royalties or fees for technical services are borne by such permanent establishment. It is this condition that it not fulfilled in the present case." the Authority, therefore, held that the applicant is not liable to withhold taxes under the Indian Income-tax Act in respect of the payments made by it to the foreign suppliers of goods, services and technologies. The Authority also held that where the matter is governed by the provisions of

the Act and also by the DTA, the provisions of the DTA should prevail unless the statutory provision is more beneficial to the assessee.

Royalties - Permanent establishment - Advance Ruling AAR P. No. 22 of 1996

18.14-2 The Authority for Advance Ruling examined the effect of article 12(7) of the India/USA Agreement, in P. No. 22 of 1996 (1999) 238 ITR 99 (AAR). It observed that the combined effect of sub-paragraphs (a) and (b) of that article is to deem royalty to arise in a State: (a) if the person paying the royalty is resident of that State; or (b) if the person paying the royalty has a permanent establishment or a fixed base there in connection with which the liability to pay is incurred and the liability is borne by such establishment or base; or (c) if the royalty relates to the use of, the right to use, the property which gives rise to the royalty in that State. On the facts and in the circumstances of the case before it, the Authority concluded that the third of these requirements is fulfilled *vis-a-vis* India, *i.e.*, the right to use trade mark in India. The Authority also observed that second part of clause (c) of section 9(1)(vi) of the Indian Income-tax Act deems royalty to accrue or arise in India where it is payable in respect of any income from any source in India, and that there is no reference to the person who is liable to pay the royalty or the business carried on by him in India. It is sufficient that the property (in this case the trade mark) in respect of which the royalty is payable is used to earn income from any source in India.

Royalties - Arisal or accrual if permanent establishment exists

18.14-3 Paragraph 5 of article 12 is a deeming provision providing that the royalties shall be deemed to arise in a Contracting State when the payer is the Contracting State itself, a political sub-division, a local authority or a resident of that State. However, it is deemed to arise in a State in which the permanent establishment or a fixed base is situated, *i.e.* ,

- where the person paying the royalties, whether he is a resident of the Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred and
- such royalties are borne by such permanent establishment or a fixed base.

Under the domestic laws, normally royalties or technical fees in respect of information or services are deemed to accrue or arise in a State in which they are put to use [see clause (c) of section 9(1)(vi) and (vii) of the Indian Income-tax Act, 1961]. But the said paragraph of the DTA requires the fulfilment of a further condition before such royalties and fees can be deemed to arise in that State where it has a permanent establishment. *viz.* , that the royalties or fees are borne by the permanent establishment. For example, income by way of royalty or technical fee payable by a person who is non-resident is deemed to arise in India if the information used or the services are utilized for the purpose of business or profession carried on by him in India. But the said provision in the DTA provides satisfaction of another condition before such arisal is so deemed, *i.e.*, of the person having permanent establishment in India and the royalties having been paid by that establishment.

Royalties - And Arm's length transactions

18.15 Paragraph 6 is another exception, besides paragraphs 4 and 5, only to a limited extent. It provides that paragraphs 1 and 2 would apply only to royalties which have been negotiated on an arm's length basis. To the excess amount as found by the application of the arm's length rule, the domestic law of the state applies. The Indian law as availed by the Finance Act, 2001, has been discussed in Chapter 53.

A similar provision exists under article 11, which is discussed in detail in paragraph 17.20. The same considerations are applicable to royalties paid in excess of what it would have been in the absence of special relationship. The paragraph permits only the adjustment of the amount of royalties and not the reclassification in such a way as to give to it a different character, *e.g.*, a contribution to equity capital.

Royalties - And the Indian Income-tax Act, 1961

18.16 Section 9(1)(vi) and (vii) of the Indian Income-tax Act, 1961 enact a special rule in respect of the accrual of the income of a non-resident in the nature of royalty and technical fees for services, and deems such income to accrue or arise in India in the circumstances set out in clauses (a) to (c) thereof. The expression "royalty" and the expression "fees for technical services" have been defined respectively in *Explanation 2* of section 9(1)(vi) and

(vii). The definitions are analogous to, though not identical with, those contained in many of the Indian tax treaties. While the definition of the expression "royalty" under the act as well as under a tax treaty are not materially different, there is a variation between the definition of "fees for technical services". The statutory definition takes into consideration of any kind for the rendering of any managerial, technical or consultancy services, it does not include consideration for any construction, assembly, mining or like project, a limitation which is not generally found in the definition embodied in the tax treaties (*see* for example, Treaty with France). The consequence is that while for the purpose of the treaty, all payments made for services will qualify as fees for technical services, such portion of payments in consideration of construction, assembly or like project will not be treated as fees for technical services in the context where application of the Indian Income-tax Act comes up for consideration. There are at least two such contexts - one in regard to the applicability of the section 115A and the other in regard to the applicability of section 44D.

Section 9(1)(vi) is operative with effect from 1-4-1976. The definition lends support that in the international commercial usage that the word 'royalty' has now come to acquire a particular meaning. In the case of secret process, patent, special inventions, when right of exploitation is given by the owner of the inventors, patents, etc., to a third party, instead of outright sale, then for the right to exploit these inventions, secret processes some amount may be paid and the amount paid may be co-related to the extent of the exploitation. Licence agreements for the exploitation of patents, inventions are being entered into in the modern commercial world and as part of such agreements, even knowledge derived from his own experience and technical know-how for the most efficient and economical user of the patents, inventions, etc., are parted with by the licensor to the licensee. Payments of this kind are known as royalties *CIT v. Ahmedabad Mfg. & Calico Printing Co.* [1983] [139 ITR 806](#) (Guj.).

Royalties - And business income under the Indian Income-tax Act Royalties - And business income under the Indian Income-tax Act

18.16-1 Section 9(1)(i) refers to all income accruing or arising whether directly or indirectly, through or from any business connection in India or through or from any property in India, or through or from any asset or source of income in India or through the transfer of capital asset situated in India. Section 9(1)(vii) refers to income by way of fees for technical services payable by Government or a resident company or non-resident company in certain circumstances. Section 9(1)(i) is a general provision, whereas section 9(1)(vii) is a special provision which refers to a particular type of income dealing with fees for technical services rendered by the foreign company. The technical services may be rendered as a result of the business connection or otherwise. But whether or not there is a business connection any income by way of fees for technical services should be taken to have been covered by the provision in section 9(1)(vii) because when there is a special provision dealing with a special type of income, such a provision could exclude a general provision dealing with the income accruing or arising out of any business connection. If the nature of an income is such as it falls under a specific provision, but on account of something in that provision or proviso or *Explanation* thereto, it cannot be subjected to tax, it cannot be brought within tax net by circumventing the general provision and extending its sweep to embrace it within its folds. When it is not possible to tax amount under section 9(1)(vii) on account of the proviso thereto, the income received by a person by way of fee for technical services rendered irrespective of whether it arises out of business connection, cannot be taxed under section 9(1)(i). Two provisions cannot operate in the same field in respect of fees for technical services - *CIT v. Copes Vulcan Inc.* [1987] [167 ITR 884](#) (Mad.).

Royalties and Technical Fees - India's approach Royalties and Technical Fees - India's approach

18.17 India follows UN model and rarely the OECD model. Rate of withholding tax has been reduced from the normal. In some treaties fees for technical services are not covered under article 12. Tax agreements with Austria, Greece, Libya and UAR give exclusive right to the state of source. The rates of withholding tax in respect of the individual tax treaties are given in the appendix. The expression "royalty" has been defines as consideration for the use of or the right to use of:

- a. Industrial property and copyright;
- b. Industrial, commercial or scientific equipment; or consideration for
- c. Information concerning industrial, commercial or scientific experience.

For the description of the kind of the royalty notations, a, b, and c are used in the appendix.

APPENDIX

WITHHOLDING TAX ROYALTIES AND FEES FOR TECHNICAL SERVICES

<i>Country</i>	<i>Royalties (%)</i>	<i>Technical fee (%)</i>	<i>Remarks</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	
Armenia	10	10	
Australia	10		For b, and forbearance thereof, Technical and consultancy services ancillary to a, b and c
	15		If the Government is the payer, or in other cases after 5 years (see below)
	20		For first five years
Austria	10		
Bangladesh	10		
Belarus	15		
Belgium	10	10 (2001) 247 ITR St. (39)	
Brazil	25	-	For a (trademark only)
	15		For a (other than trademark), b and c
Bulgaria	15	20	For a (copyrights only other than cinematograph films for broad casting)
	20		For a (other than above), b and c

Canada	15	If the Government is the payer, or Same as in Column 2	
		in other cases after 5 years (<i>see</i>	
		below), for a and c	
	20	For first 5 years for a and c (<i>see</i> above)	
	10	For b	
China	10		10
Cyprus	15		15
Czech Republic	10		10
Denmark	20		20
Finland	30		30
Finland	15	if the Government is the payer, or in other cases after 5 years (<i>see</i> below), for <i>a</i> and <i>c</i>	Same as in Column 2
	20	For first five years (<i>see</i> above), for <i>a</i> and <i>c</i>	
	10	For <i>b</i>	
France	10	10 [2000] 111	
			Taxman 44 (St.)
Germany	10		10
Hungary	10		10
Indonesia	15		-
Ireland	10		10

Israel	10	10
Italy	20	20
Japan	10	10
Jordan	20	20
Kazakhstan	10	10
Kenya	20	-
Korea	15	15
Kyrgyz		
Republic	15	15
Malaysia	10	10
Malta	15	15
Mongolia	15	15
Mauritius	15	-
Morocco	10	10
Namibia	10	10
Nepal	15	-
Netherlands	10	10 [1999] 239 ITR 56 (St.)
New Zealand	10	10 [Second Protocol, [2000] 242 ITR 147 (St.)]
Norway	20	20
Oman	15	15
Philippines	15	-
Poland	22.5	22.5
Portugal	10	10
Qatar	10	10

Romania	22.5		22.5
Russia	10		
Singapore	10	For b	10
			10
	15	For a and c	
Slovenia	10		10
South Africa	10		10
Spain	10	For b	20
	20	For a and c	
Sri Lanka	10		-
Sudan	10		10
Sweden	10		10
Switzerland	10		10
Syria	10		-
Tanzania	20		-
Thailand	15		-
Trinidad and			-
Tobago	10		10
Turkey	15		15
Turkmenistan	10	10	
UAE	10		10
UK	15	If the Government is the payer, or in other cases after 5 years (see below), for a and c	Same in the case of royalty
	20	For first 5 years (see above), for a	

		and c	
	10	For b	
USA	Same as above in the case of UK		
Uganda	10		10
Ukraine	10		10
Uzbekistan	15		15
Vietnam	10		10
Zambia	10		-

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - CAPITAL GAINS

ARTICLE 13

CAPITAL GAINS

1. *Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.*
2. *Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.*
3. *Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
4. *Gains from the alienation of shares of the capital stock of a company or of an interest in a partnership, trust or estates the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.*

In particular :

- (1) *Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.*
- (2) *For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.*

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of... per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

Introduction

19.1 Article 13 deals with gains derived from the alienation of (1) immovable property, (2) movable property forming part of the business property of the permanent establishment or fixed base (3) ships or aircraft, (4) shares of capital stock company the property of which consists of principally of immovable property, (5) shares of other companies representing a participation of (as negotiated) per cent in a company which is resident of a Contracting State, and (6) any other property. The State in which the gains may be taxed is that where it situated:—

- the property as mentioned in (1) and (4) above;
- the permanent establishment or the fixed base, item (2);
- the effective management of the enterprise; item (3).

State in which it is taxed where lies

- the residence of the company, item (5);
- the residence of the alienator, item (6).

Article 13 is intended to apply only if there is alienation of the property, and not when it appreciates in value on account of appreciation in currency in terms of the currency of the situs country or any other account though some countries may levy capital appreciating (increment) taxes. It does not apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures.

"Gains" from the "alienation" of the property of the nature as specified in paragraphs 1 to 6 is the subject-matter of article 13. The right to capital gains tax has been given to the state of which the alienator is a resident. The exceptions are the immovable property, movable property forming part of the business property of the permanent establishment, ships or aircraft, and, shares. The conditions on which the exception operates are contained in paragraphs 1 to 5.

In other words, the Article deals first with the gains which may be taxed in the State where the alienated property is situated. For all other capital gains, paragraph 6 gives the right to tax to the State of which the alienator is a resident. As a rule the right to tax is conferred on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business of the permanent establishment prior right to tax belongs to the State where such property is situated. This appears to be based on the general rule as stated in paragraph 4 of the OECD Commentary on Article 13 :

"It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom. The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is capital gain or a business profit. Accordingly, no distinction between the capital gains and commercial profits is made nor is it necessary to have a special provision as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question."

Capital gains - State source rightCapital gains - State source right

19.1-1 Paragraph 1 preserves the right of the State of source to tax gains from the alienation of immovable property situated in that State and also from immovable property forming part of the assets of the enterprise. It deals only with the gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other Contracting State and not with the gains in respect of the property in the Contracting State of which the alienator is a resident or situated in the third State.

There are circumstances when the entire gains derived from the alienation of property may not be taxed in State of situs; the State of residence has also a right of tax. For example, the State where property belonging to the enterprise of another State is situated cannot tax depreciation allowance in respect of that property allowed in

another State (paragraph 14 of the Commentary) which the latter alone has the right to tax (OECD Commentary, paragraphs 14 and 15).

Capital gains - Kinds of items not covered Capital gains - Kinds of items not covered

19.1-2 Article 13 does not apply to the following cases—

- ◆ Distribution of profits on liquidation of a company is taxed as dividend and not as capital gain, by State of residence (OECD Commentary, article 13, paragraph 31);
- ◆ Redeeming of bonds and debentures at a price at which they were issued or the price which is higher than the par value does not result in capital gains. The difference represents interest subjected to a limited tax in the State of Source (Commentary, paragraph 31);
- ◆ Alienation of shares acquired upon the exercise of a stock-option granted to an employee or a member of the board of directors, which is taxed under articles 15 and 16 respectively (OECD Commentary, paragraph 32);
- ◆ Gains due to changes of the rate of exchange are not connected with an alienation of the asset and, therefore, not taxable as capital gains (OECD Commentary, paragraph 17);
- ◆ Annuity payments so far as they exceed the costs may or may not be taken as gain from the alienation of property (*see* OECD Commentary, paragraph 18);
- ◆ Prizes in a lottery or premiums and prizes attaching to bonds or debentures do not result in capital gains to be covered under article 13 (*see* OECD Commentary, paragraph 19).

Capital gains - Gains meaningCapital gains - Gains meaning

19.2 The Article does not give a detailed definition of "capital gains", whether or how they are to be taxed. The matter is left to the Contracting States to decide. (*see* OECD Commentary, article 13, paragraph 3). It does not distinguish the origin of the capital gains. Therefore all capital gains are covered as those—

- accruing over a long term;
- accruing in a very short period (speculative gains);

(*see* OECD Commentary, article 13, paragraph 11).

The basic concept of capital gains is that the property which involves a certain cost of acquisition to the owner gains an increment in its value over a period of time during which it is being retained by the owner and yields a profit when he disposes it and realises the proceeds. The unearned income is realised at the time of sale or disposal. Accordingly, in order to determine capital gains it is necessary to reckon not only the amount of realisation at the point of sale but also the cost of the property at the time of acquisition or at any point of time taken as standard for measuring the increment in value. Appreciation in value because of the appreciation of currency or on account of inflation cannot be said to be the increment of the value for the purpose of capital gains tax. A chargeable gain imports the following elements : (1) acquisition of an asset; (2) an increase in the capital value of the asset whilst in the ownership of the person to be charged; (3) a disposal of the asset giving rise to a realisation of gain which has accrued during the period of ownership. A taxing statute is concerned with property, and with alienation and the gains arising as a result thereof. The two features of capital gains tax are the (1) property, and (2) alienation thereof.

Capital gains - Property, meaningCapital gains - Property, meaning

19.3 The "property" is a term of widest import and includes every specie of an estate, real or personal, and everything which one person can own and transfer to another. It extends to every specie of right and interest capable of being enjoyed as such. It includes not only tangible property, but also intangible rights - *Pandit Lakshmi Kant Jha v. CWT* [1973] [90 ITR 97](#) (SC) and *Ahmed G.H. Ariff v. CWT* [1970] 76 ITR 471 (SC). In the context of a taxing statute which is concerned with the assets, and with the disposal and acquisition, gains and losses, "property" bears the meaning of that which is capable of being owned in the legal sense - *Kriby (Inspector of Taxes) v. Thorn E.M.I. PLC* [1990] 183 ITR 503 (CA). Every interest and every right which is capable of being owned and disposed is a property. Interest in its normal acceptation means one or more of those rights which go to make up ownership. It will include, for example, mortgage, lease, charge, easement and the like - *Collector of Bombay v. Nusserwanji Rattanji Mistri* AIR 1955 SC 298. Any possible interest which a person can acquire, hold and enjoy is a property, including interest in a property terminable after a specific period whether with the efflux of time or by notice - *J.K. Trust v. CIT* [1957] [32 ITR 535](#) (SC) and *Ahmed G.H. Ariff v. CWT* [1970] [76 ITR 471](#) (SC). Property

means the highest right that a man can have to anything, being that right which one has to lands or tenements, goods or chattels, which does not depend on another's courtesy and it includes ownership, estate or interest in corporeal things, and signifies a beneficial right thereto or thing having money value - *Rustom Cavasjee Cooper v. Union of India* AIR 1970 SC 564.

The word "right" in the property is to be distinguished from "interest" and the enforcement of the right and the remedy. Right in respect of the property is again to be distinguished from a right in the property. Interest is a specie of right. It is that right which is in the nature of ownership but does not necessarily connote title. An interest is a right in rem in respect of the property - *Multi Rise Towers (P.) Ltd. v. Appropriate Authority* [1995] [211 ITR 102](#) (Cal.). The expression "property", therefore, signifies every possible interest which a person can clearly hold and enjoy - United Nations model Double Taxation Convention between Developed and Developing Countries, ST/ESA/102, United Nations, New York, 1980. For the purposes of allocation to the state jurisdiction to charge capital gain tax, the kinds of property dealt with in article 13 are : immovable property (paragraph 1); movable property forming part of the permanent establishment or the fixed base (Paragraph 2); ships or aircraft (paragraph 3); Shares in a company the property of which consists principally of immovable property (paragraph 4), shares representing a participation of prescribed percentage (paragraph 5). Capital gains are taxed by the source state under the mentioned conditions. These are the provisions which are carved out as exceptions to the general rule as referred to in paragraph 6 that the gains shall be taxable only in the contracting state of which the alienator is resident.

Capital gains property - Immovable Capital gains property - Immovable

19.3-1 The expression "immovable property" has been defined with reference to article 6.

Capital gains property - Movable Capital gains property - Movable

19.3-2 The term 'movable property' means all property other than 'immovable property' dealt with in paragraph 1 of article 13 of the OECD or UN Model. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such asset may be taxed in the State in which permanent establishment or fixed base is situated, which correspond to the rules for business profits and for income from independent personal services (articles 7 and 14).

Capital gains property - Shares Capital gains property - Shares

19.3-3 A share is a chose in action, implying the existence of some persons entitled to the rights which are rights in action as distinct from right in possession - *V.G.M. Mouldings Ltd., In re* [1942] 12 Comp. Cas. 254 (CA) and *CIT v. Master Raghuvver Trust* [1985] [151 ITR 368](#) (Kar.). A share itself is an object of dominion, *i.e.*, the right in rem. A shareholder has right to receive dividends, to attend meeting and vote, right to participate in the assets of the company on its winding and liquidation - *Anarkali Sarabhai v. CIT* [1982] [138 ITR 437](#) (Guj.). A share, therefore, carries a right to participate in the company's profits without being debt-claims.

Capital gain, property - Alienation Capital gain, property - Alienation

19.4 The expression "alienation of property" has not been defined in the convention.

The words "alienation of property" are used to cover capital gains resulting from—

- the sale or exchange of property and also from a partial alienation,
- the expropriation,
- the transfer to a company in exchange for stock,
- the sale of a right,
- the gift, and
- even the passing of property on death

(see OECD Commentary, article 13, paragraph 5)

In a general sense it connotes the passing of rights in property from one person to another. In one case, there may be passing of the entire bundle of rights from the transferor to the transferee. In another case, the transfer may consist of one of the estates only out of the estates comprising the totality of rights in the property. In a third case, there may be a reduction of the exclusive interest in the totality of rights of the original owner into a joint or shared interest with other persons. An exclusive interest in property is a larger interest than a share in that property. To the

extent to which the exclusive interest is reduced to a shared interest, it would seem that there is a transfer of interest - *Sunil Siddharthbhai v. CIT* [1985] [156 ITR 509](#) (SC). Thus, for example, when a partner brings in his personal asset into the capital of the partnership firm as his contribution to its capital, he reduces his exclusive rights in the asset to the shared rights in it with the other partners of the firm. While he does not lose his rights in the asset altogether what he enjoys now is an abridged right which cannot be identified with fullness of the right which he enjoyed in the asset before it entered the partnership capital. This cannot be read for holding that the position in law as on the dissolution of and as on the retirement of a partner from the firm is the same - *N.A. Mody v. CIT* [1986] [162 ITR 420](#) (Bom.).

The word 'alienation' is not normally defined in the tax agreement and, therefore, its meaning may be gathered from the domestic law. The agreement with Mauritius has, however, defined it to mean sale, exchange, transfer or relinquishment of the property or the extinguishment of any rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States. Similar definition is contained in agreements with Sri Lanka, Syrian Arab Republic, Tanzania and Zambia. This definition almost corresponds to the definition of the word 'transfer' with reference to capital gains, in section 2(47) of the Indian Income-tax Act prior to its amendment by the Finance Act, 1987 with effect from 1-4-1988. Any transaction involving allowing possession of immovable property in part performance of the contract of the nature referred to in section 53A of the Transfer of Property Act, 1882, or the transaction which has the effect of transferring or enabling the enjoyment of immovable property, has also been deemed to be transfer.

However, consequence of only 'sale', 'exchange' or 'transfer' may mean capital gains for the treaty agreements with Austria, Belgium, Denmark, France, Greece, Japan, Norway and Sweden. Relinquishment or extinguishment of rights in the property has been found missing, as also the reference to the compulsory acquisition of property. Such absence, however, does not mean compulsory acquisition may not be taken 'transfer' of asset. In the absence of a distinct genus or category no presumption can arise that the word 'alienation' must be construed in the sense of a voluntary act of transfer since 'sale', 'exchange' or 'relinquishment' are in the normal acceptance of those terms of voluntary acts. The words sale, exchange, relinquishment and transfer must be given their plain and natural meaning and there is no justification for restricting the wide comprehension of the word 'transfer' to voluntary transfers by the application of the *ejusdem generis* rule. If it is intended that voluntary transfers alone should fall within the meaning of the article, it is unnecessary to use the word 'alienation', an expression acknowledged in law as having a wide connotation and amplitude. If an existing title in a capital asset is extinguished and new one created, there is a transfer of capital asset. The fact that the divestiture of title takes place under a law relating to compulsory acquisition of property would make no difference - *Mangalore Electric Supply Co. Ltd. v. CIT* [1978] [113 ITR 655](#) (SC).

The word 'alienation' is, therefore, used to mean extinguishment or relinquishment of rights in the capital asset. Since the transfer as contemplated is one as a result whereof consideration has passed to the assessee or has accrued to him, extinguishment or relinquishment of rights must relate to that 'capital asset' corporeal or incorporeal. It is, therefore, obvious that a transfer of a capital asset in order to attract liability to tax under the head 'Capital gains' must be a 'transfer' as a result whereof some consideration is received by or accrues to the assessee. If the transfer does not yield any consideration, there can be no question of capital gains. If the transfer takes effect on extinguishment of a right in the capital asset, there must be receipt of consideration for such extinguishment to attract liability to tax - *Baroda Cement & Chemicals Ltd. v. CIT* [1986] [158 ITR 636](#) (Guj.).

The word 'transfer' does not cover cases which result in the destruction, annihilation, extinction, termination, cessation or cancellation, of all or any of the bundle or rights which a person has in the capital assets - *Vania Silk Mills (P.) Ltd. v. CIT* [1991] [191 ITR 647](#) (SC). However, under the Indian Income-tax Act, 1961 damages, received on such destruction from insurer are taxable.

Capital gains - Sale, meaning

19.5 Ordinary meaning of the word 'sale' is a transaction entered into voluntarily between two persons known as buyer and the seller by which the buyer acquires the property for an agreed consideration known as price - *Calcutta Electric Supply Corpn. Ltd. v. CIT* [1951] [19 ITR 406](#) (Cal.).

Eric L. Kohler in *A. Dictionary for Accountants*, 1978 edition, defines 'sale' in the following words:

"1. A business transaction involving the delivery (*i.e.*, the giving) of a commodity, an item to merchandise or property a right, or a service, in exchange for (the receipt of) cash, a promise to pay, or money equivalent, or

for any combination of these items. It is recorded and reported in terms of the amount of such cash, promise to pay, or money equivalent. A sale is sometimes distinguished from an exchange (*I*), particularly in the phrase 'sale or exchange', where the letter is confined to transactions involving no cash or an incidental amount of cash, thus being used in the sense of barter; but except for such use or where specifically qualified, the term extends to any transaction where something is parted with and as compensation therefor something is received. A sale differs from gift, for which there is no consideration, from a bailment, which involves no transfer of title, and from a chattel mortgage, under which a transfer can occur only in case of default on the obligation it secures.

2. *PI*. the aggregate of such recorded and reported amounts during any given accounting period, appearing on books of account as a credit. On an income statement unless otherwise qualified, sales are net, *i.e.*, gross less returns, allowances, discounts and (rarely) provision for uncollectible accounts."

According to section 2(*h*) of the Central Sales Tax Act, 1956, 'sale price' means the amount payable to a dealer as consideration for the sale of any goods, less any sum allowed such as discount according to the practice normally prevailing in the trade, but inclusive of any sum charged for anything done by the dealer in respect of the goods at the time of or before the delivery thereof other than the cost of freight or delivery or the cost of installation in cases where such cost is separately charged.

'Sale', according to its ordinary meaning, is a transfer of property for a price - *CIT v. Dewas Cine Corpn.* [1968] [68 ITR 240](#) (SC) and *CIT v. Motors & General Stores (P.) Ltd.* [1967] [66 ITR 692](#) (SC). 'Sale' according to section 54 of the Transfer of Property Act, is a transfer of ownership in exchange for a price paid or promised or part paid or part promised. There is, however, no definition of 'price' in that Act. But it is well settled that the word 'price' is used in the same sense as in Sale of Goods Act, 1930. Section 2(*I*) of the said Act defines 'price' as meaning the money consideration for a sale of goods. According to section 4 of the Sale of Goods Act, there should be a transfer on sale of goods or property in goods by the seller to the buyer for a price. No doubt the contract of sale of goods may be one entered into between one part of the owner and another. It may also be absolute or conditional. However, the heart of the matter is that there should be a transfer of property by the vendor called the seller and the vendee, the purchaser, for a price. Unless these ingredients of a valid sale are satisfied or established, it cannot be said that the transaction in question would amount to sale - *CIT v. Srinivas Bus Service* [1974] [94 ITR 454](#) (AP).

A sale comprises of the following essential elements:

- ◆ There must be parties competent to contract
- ◆ There must be mutual contract
- ◆ There must be a thing which is transferred from the seller to the buyer
- ◆ There must be price in money paid or promised.

Capital gains - Compelled sale Capital gains - Compelled sale

19.5-1 A contract for sale thus postulates exercise of volition on the part of the contracting parties. As held by the Supreme Court in *New India Sugar Mills Ltd. v. CST* [1963] 14 STC 316 unless there is an exercise of volition on the part of the contracting parties, the mere use of the word 'sale' will not make it a sale. The manufacturer of sugar was directed by the orders of the Sugar Controller to despatch sugar to various States. There was no consensus or contract between the manufacturer and the State to which the goods were consigned. However, as pointed out by the Supreme Court in *State of Rajasthan v. Karam Chand Thappar & Bros.* - [1969] 23 STC 210, there could be free consent of parties to a sale, in spite of certain statutory compulsions. The consent under the law of contract need not be express but could be implied. A sale could also take place by operation of law rather than by mutual agreement, express or implied. Although there might be compulsion both in selling and buying, a compelled sale is nevertheless a sale and it cannot be said that there is no sale because the freedom to offer and accept is wanting - *CST v. Ram Bilas Ram Gopal* [1969] 24 STC 508 (All.)(FB).

A compelled sale under a statutory obligation is sale in the sense that there is a privity of contract between the seller and the purchaser for the transfer of goods, for a consideration, which passes from the latter to the former. But where the Government acquires a property and pays compensation to its owner, the transfer cannot be taken sale. The essential ingredients of sale are lacking. The 'price' is only a compensation for the compulsory passing off the property in goods to which the order of acquisition relates, at an amount fixed by the authority, though the compensation is determined on some generally fixed principle.

In *Calcutta Electric Supply Corpn. Ltd. v. CIT* [1951] [19 ITR 406](#) (Cal.) an electric generator was acquired compulsorily under the Defence of India Rules in spite of owner's protest and it was held that the transaction or transfer thus brought about did not amount to sale. If, however, the purchase by the Government of an asset was the result of a contract, such a transaction amounts to sale - *Fazilka Electric Supply Co. Ltd. v. CIT* [1959] [36 ITR 411](#) (Punj.). In *John Hudson & Co. Ltd. v. Kirkness* (H.M. Inspector of Taxes) 36 TC 28 certain wagons were requisitioned and these were acquired by the Government. A contention was raised that the acquisition amounted to a transfer for a price and therefore, it was a sale. This contention was rejected by a majority of the House of Lords. The Madhya Pradesh High Court in *CIT v. Shrikrishan Chandmal* [1963] 47 ITR 833, held that though compulsory acquisition by the Government may not constitute a sale, it would still be a 'transfer'. So was held by the Supreme Court in *James Anderson v. CIT* [1960] [39 ITR 123](#) and other High Courts - *Vadilal Soda Ice Factory v. CIT* [1971] [80 ITR 711](#) (Guj.), *CIT v. Dr. P. Rajendran* [1981] [127 ITR 810](#) (Ker.), *CIT v. United India Life Assurance Co. Ltd.* [1966] [62 ITR 610](#) (Mad.), *West Coast Electric Supply Corpn. Ltd. v. CIT* [1977] [107 ITR 483](#) (Mad.) and *Wilfred Pereira Ltd. v. CIT* [1964] [53 ITR 747](#) (Mad.).

The word 'transfer' is comprehensive and is regarded generally as comprehending within its scope transfers both voluntary and involuntary, that in the absence of a distinct genus or category, no presumption can arise that the word 'transfer' in section 2(47) must be construed in the sense of a voluntary transfer, because the words 'sale', 'exchange' and 'relinquishment' are in the normal acceptance of those terms as voluntary acts, and that, therefore, if an existing title of a capital asset is extinguished and a new one created, there is within the meaning of section 2(47) a 'transfer' of capital asset, and that the fact the divestiture of title takes place under a law relating to compulsory acquisition of property would make no difference. The compulsory acquisition of capital asset may be a 'transfer' within the meaning of section 2(47), but is not sale. These expressions are not synonymous conveying the same meaning. Had this been so, and also the expression 'sale' as embracing within its scope 'compulsory acquisition' of an asset, there would have been no need to refer to both these expressions in the inclusive definition of 'transfer' in section 2(47). One of the purposes of the inclusive definition is to expand the concept defined. The meaning of the expression 'transfer' was extended to cover the compulsory acquisition of an asset along with sale, exchange, relinquishment of an asset, or extinguishment of any right therein.

Capital gains - Hire-purchase Capital gains - Hire-purchase

19.5-2 In a contract of sale the seller transfers or agrees to transfer the property to the buyer for a price. Hire-purchase agreement is a contract for the hire of an asset which contains a provision giving the hirer an option to acquire legal title to the asset upon the fulfilment of certain conditions stated in the contract. It is the nature of a contract of bailment with an element of sale added to it. A hire-purchase agreement has two elements : (1) element of bailment, and (2) element of sale, in the sense that it contemplates an eventual sale. The element of sale fructifies when the option is exercised by the intending purchaser after fulfilling the terms of agreement. When all the terms of the agreement are satisfied and the option is exercised a sale takes place of the goods which till then have been hired - *K.L. Johar & Co. v. Dy. CTO* [1965] 16 STC 213 (SC). In a sale where price is payable by instalments, property nonetheless passes on the date of the contract, while in a hire-purchase agreement it passes when the option is finally exercised by the intending purchaser after complying with all the terms of the agreement.

The Allahabad High Court in *Shyam Kumar Verma v. S.P. Misra* AIR 1959 All. 498 held that the test to know if an agreement is by way of hire-purchase agreement is whether the hirer has an option to terminate the bailment at anytime he likes, and secondly, whether, on default of any payment by the hirer, the owner of the article has reserved the right to terminate the agreement and to resume the possession of the article. It is only when either of the elements is present, the agreement can be taken as a 'hire-purchase' agreement. According to *Halsbury's Laws of England*, as term 'hire-purchase' properly applies only to contracts of hire conferring an option to purchase, but it is often used to describe contracts which are in reality agreements to purchase chattels by instalments, subject to a condition that the property in them is not to pass until the instalments have been paid.

The hire-purchase contract fixes the total amount payable by the hirer- *cum*-purchaser which exceeds the original price of the asset by an amount which may be called hire charges. If on entering into a hire-purchase agreement a clear distinction is made between the price for which the asset is sold and the hire charges which are payable only if the price for the asset is not paid at the time of the transfer of property, then it would be arguable that the hire charges should not be regarded as a part of the price of the asset. This argument would gather force if an option were to be given to the hire-*cum*-purchaser to pay the full price of the asset without hire charges at the time of the transfer of the goods or to exempt from paying the proportionate hire charges if before the expiry of the hire-

purchase period he were to pay the full price. The hire charges are for the actual period of delay in paying the full price, but they should not be payable when he exercise the option earlier than the while stipulated period of the hire-purchase contract. On the other hand, if the whole of the amount payable by the hire-purchaser is consolidated and instalments are made payable without giving any right to the hirer-*cum*-purchaser to buy the asset at the original price without paying the hire charges or earlier than the expiry of the whole period of the hire-purchase after paying the proportionate hire charges for that part of the hire-purchase period which is yet to expire, then no distinction can be made between the price and the hire charges because the whole of the amount is the consideration for the hire-purchase and hence for the transfer of the goods in hire-purchase.

The hire-purchase consideration has to be split up into two parts, namely, the amount paid as consideration for the use of the asset so long as it is the property of the owner and the payment for the option on a future date to purchase the asset at a nominal price. The former would represent the hire charges and the latter sale price. To sum up, whether a transaction is an outright sale on deferred payment or is a hire-purchase, depends on the terms of the agreement governing the transaction. In case it is the former, sale is said to be complete when the vendee has secured the possession of goods, and in the latter when the hirer-*cum*-purchaser has paid all the instalments. The consideration agreed upon in the former case represents sale proceeds and in the latter case it is to be paid in instalments which consists of the price of the goods and the hire charges. An exercise has, therefore, to be made to find out how much amount represents price and how much hire charges, depending on facts of each case. The amount which is referable to price is sale proceeds.

Capital gain sale - Hire purchasing and finance leasing Capital gain sale - Hire purchasing and finance leasing

19.5-3 A lease is a contract between a lessor and lessee for the hire of a specific asset. The lessor retains the ownership of the asset but conveys the right to use it to the lessee for an agreed period of time in return for the payment of specified rentals. A lease consists of a right to the possession and use of the property owned by some other person. It is an outcome of the separation of ownership and possession - *A.R. Krishnamurthy & A.R. Rajagopalan v. CIT* [1982] [133 ITR 922](#) (Mad.). Thus, the basic characteristic of the concept of leasing is the divorce between 'ownership' and 'use' of the asset.

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not pass. Finance lease is not normally cancellable. It ensures the lessor the recovery of his capital outlay *plus* a return for the funds invested by him. If the lease does not transfer substantially all the risks and rewards of ownership (other than legal title) to the lessee, the lease is not a finance lease but an operating lease. Under an operating lease, the risks and rewards incident to ownership of an asset remain with the lessor. Therefore, the asset is treated by the lessor as a depreciable asset and the rental receivable are included in income over the lease period. A manufacturer or dealer less or does not recognise any selling profit on entering into an operating lease because it is not equivalent to sale.

The finance lease has characteristics of a hire-purchase contract and should be treated similarly. Under the finance lease rights of possession and enjoyment are transferred to the lessee and only the formality of transferring the legal ownership remains to be completed on the expiry of the lease period. The rentals receivable are usually treated by the lessor as repayment of principal and finance income to reimburse and reward for his investment. The total amount receivable over the period of lease might represent the sale price as in hire-purchase contract similar to the one in the case of *CIT v. Madras Autorickshaw Drivers' Co-operative Society Ltd.* [1983] [143 ITR 981](#) (Mad.) or in the case of *Sundaram Finance Ltd. v. State of Kerala* [1966] 17 STC 489 (SC).

In the case of hire-purchase contract, the Supreme Court in *K.L. Johar & Co. v. Dy. CTO* [1965] 16 STC 213 held that the sales tax authorities may split up the hire in two parts, namely, the amount paid as consideration for the use of the asset so long as it was the property of the owner, and the payment for the option on a future date to purchase the asset at a nominal price. If the first part is determined the rest would be towards the payment of price. The first may be determined after finding out the proper amount to be paid as hire in the market for the asset of the type concerned, or in such other manner as may be available with the authorities. The second method may be to take the original price fixed in the hire-purchase agreement and to calculate the depreciation and all other factors that may be relevant in arriving at the price when the second sale takes place to the hirer, including the condition of the asset at the time of second sale. Similarly, in the case of finance lease, the lease has to be split into two parts; namely, (a) the amount representing the fair value of the asset (that is price at which an asset could be sold or exchanged in the open market between a willing purchaser and willing seller) at the inception of the lease, which would represent its

sale price; and (b) amount reflecting periodic rate of return on lessor's net cash investment in the lease in each period.

Capital gains - LeaseCapital gains - Lease

19.6 A lease of a property is a transfer of a right to enjoy such property made for a certain time, express or implied, or in perpetuity, in consideration for a price paid or promised, or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by transferee who accepts the transfer on such terms [section 105 of the Transfer of Property Act]. A lease consists of a right to the possession and use of the property owned by some other person. It is an outcome of the separation of ownership and possession. Lessor of land is one who owns and possesses it, but has transferred the possession to another - *A.R. Krishnamurthy & A.R. Rajagopalan v. CIT* [1982] [133 ITR 922](#) (Mad.). But mere occupation is not a possession although every physical possession is occupation. Possession is a legal concept and one of the ingredients which is essential to it is the specification of actual period of time when act of possession as possession commences and not merely as an act of occupation - *Turab Ghosi v. Smt. Laxmi Agrawal* AIR 1984 All. 180. A lease is not a mere contract but it is a transfer of interest in land and creates a right *in rem*. Even in case where a lease in perpetuity is granted interest still remains in the lessor which is called reversion. The stipulation relating to renewal could not be regarded as transferring property or any right therein - *R. Kempraj v. Burton Son & Co. (P.) Ltd.* AIR 1970 SC 1872.

Normally, a mere right to renew a lease does not create a contract between the parties, whether such right is burdened with conditions or not. It is only when the said right is exercised by the lessee that a contract is created between the parties resulting in interest in the property - *Seth Ramnath K. Daga v. CWT* [1981] [127 ITR 371](#) (Bom.). A lease is heritable and transferable. If the lease is for a fixed period with an option to renewal whether of the tenant or the lessor, it does not affect the duration of the term, the reason being that the option until exercised creates no interest in the leased property. But according to *Explanation* to sub-clause (i) of clause (f) of section 269U of the Indian Income-tax Act, 1961 a provision in the instrument of lease for extension of the period for which the lease is granted exceeds twelve years together with the period of original term would mean that such an instrument is an instrument of transfer of immovable property within the meaning of that section.

In case, however, a lessee continues possessing the property after determination of the lease, with the lessor's consent, the tenant is said to be a tenant holding over. When the tenant continues without the consent of the landlord, he is called tenant by sufferance. The assent may be expressed by acceptance of rent by the lessor or otherwise assenting to his possession. If there is no evidence to show that the lessor tried to evict the tenant, who had continued the peaceful possession and enjoyment of the properties all along. Such an act may lead one to infer that the lease is for a period longer than what it is made to appear.

Capital gains - Lease and licenceCapital gains - Lease and licence

19.6-1 There is a marked distinction between lease and licence. The following propositions may be taken well established :

- ◆ To ascertain whether a document creates a licence or lease, the substance of the document must be preferred to the form.
- ◆ The real test is the intention of the parties whether they intend to create a lease or licence.
- ◆ If the document creates an interest in the property, it is a lease; but if it only permits other to make use of the property on which the legal possession continues with the owner, it is licence.
- ◆ If under a document a party gains exclusive possession of the property, *prima facie*, he is considered to be a tenant; but circumstances may be established which negative the intention to create a lease.

Capital gains - Lease and saleCapital gains - Lease and sale

19.6-2 In sale there is absolute transfer of all rights in the property sold, but in a lease there is a partial transfer or divesting of the rights left in the transferor which are called reversion - *S.B. Housing & Land (P.) Ltd. v. CIT* [1979] [119 ITR 785](#) (Cal.)

Capital gains - ExchangeCapital gains - Exchange

19.7 The expression exchange has been defined in section 118 of the Transfer of Property Act. It says that when two persons mutually transfer the ownership of one thing for the ownership of another, the transaction is called an

exchange. Exchange is confined to transactions involving no cash or an incidental amount of cash. It is being used in the sense of barter. But except for such use or where specifically qualified, the term extends to any transaction where something is parted with and as compensation therefor something is received. That something may be anything having value, but not the money.

Capital gains - Allowing possession in part performance of contract

19.8 The act of allowing possession of immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act is deemed to be transfer for the purpose of Indian Income-tax Act, by the amendment with effect from 1-4-1988. The conditions necessary for the application of this provision are as follows :

- ◆ The transferor has contracted to transfer for consideration an immovable property
- ◆ The transferee has in part performance of the contract taken possession of the property or any part thereof, or the transferee being already in possession continues in possession in part performance of the contract.

The contract should be of the nature as referred to in section 53A of the said Act. It may be akin to but not quite the same contract as referred to in that section. There should be vested in the contract certain elements which could invest it with the character of a contract as resembling the one entered into in terms of section 53A of that Act. The expression 'of the nature' appears to have been deliberately employed. This expression is of much wide connotation inasmuch as it would take within its ambit not merely a contract *strict sensuo* falling within the meaning of section 53A, but also all others of allied nature partaking of some, if not all, of the characteristics of section 53A. The phrase has indeed a wide amplitude and its use leaves little doubt that the intention of the Legislature, especially when it enacted provision for curbing tax evasion, in employing it was to cast the net sufficiently wide so as to bring within its field all types of contract whereunder possession of the property or its retention is allowed in part performance of the contract for transfer of the property.

Section 53A of the Transfer of Property Act creates certain rights which were not in existence before the enactment was passed. These rights to retain possession rest upon the express provisions of the statute. One of the rights conferred is a right to the person to protect his possession. The transferor or his successors-in-interest are debarred from enforcing any right or interest expressly provided by the agreement to sell under which the transferee is put in possession - *CIT v. B.L. Dhingra & Sons* [1985] [153 ITR 167](#) (Delhi). The right is restricted to two aspects, namely, (a) there must be a written contract; and (b) it is only available as a defence. The other aspect that the right under section 53A of the Transfer of Property Act does not create any title or award any interest in the property to the transferee and is limited to protect his possession, is not relevant so long as the transferee has been allowed possession of the property in part performance of the contract of transfer.

Capital gains - Allowing possession referable to contract - Allowing possession

19.8-1 The condition necessary for the application of this clause is that the possession is allowed in part performance of the contract of transfer, *i.e.*, the possession should be referable to such contract. Absence of the nexus between the act of possessing the property and the contract of transfer would militate against the concept of transfer.

An act of part performance must be an act done in the performance of the contract, *i.e.*, it should conform to the provisions of the contract and aim at furtherance towards its completion or implementation. Conditions necessary for making out the defence of part performance to an action are as follows - *Nathulal v. Phool Chand* AIR 1970 SC 546.

- ◆ The transferor has contracted a transfer for consideration any immovable property by an agreement executed by him or on his behalf from which the terms necessary to constitute the transfer can be ascertained with reasonable certainty.
- ◆ The transferee has in part performance of the contract taken possession of the property or any part thereof or the transferee being already in possession continues in possession in part performance of the contract.
- ◆ The transferee has done some act in furtherance of the contract.
- ◆ The transferee has performed or is willing to perform his part of the contract.

Capital gains - Agreement or arrangement for transferring enjoyment of property

19.9 The expression 'transfer' in section 2(47) of the Indian Income-tax Act as amended by the Finance Act, 1987, covers every possible mode of transfer resorted to by persons to exchange properties or rights therein for a consideration. A person may become owner of a building in various ways. He may have inherited the building and the land on which it stands from his parents and some other persons. He may have purchased the land and then constructed the building thereon. He may have taken the land on lease and constructed the building thereon. Or he may have acquired the land as well as the building from somebody else. In the four set of circumstances outlined above, there is a transfer of ownership from one person to another in respect of building. This transfer may be by way of sale, gift or exchange and, if so, under the Transfer of Property Act, 1882, the transfer of ownership can be effected only by means of a registered document [*vide* sections 54, 118 and 123]. However, in recent times various other devices are sought to be employed for transferring one's ownership in property. This is due to various reasons. In the first place, the drawing up of a sale deed and its registration involve considerable expenses by way of stamp duty and registration charges. Allowing a person to possess, occupy and enjoy a property for a consideration, in pursuance of agreement, in terms of section 53A of the Transfer of Property Act, is such an instance. Secondly, in some places there are restrictions on the transfer of property and parties desire to circumvent these restrictions. Thirdly, due to shortage of space in big cities, house property takes the shapes of flats, a large number of them constitute one building, the ownership of which is more conveniently held through membership of companies or co-operative societies where there is a dichotomy between share or interest in the capital and the interest in the property of the company/society. Though the building/flat is owned by the company/society the shareholder/member has a right or interest to occupy the flat. This specie of property, namely, the right to occupy a flat requires significant importance and acquires under the law a stamp of transferability in furtherance of the interest of commerce.

There is a distinction between the right of a member of the society to hold shares and the right to occupy the flat. The right to occupy the flat is treated as distinct right, though it is inextricably connected with the right to hold a share. The right to occupy naturally flows from the right to hold share, though the former is a distinct and a separate right recognised in law. Such a right is clearly alienable and heritable. That right is clearly a right arising out of the flat which is nothing but a building. *Prima facie*, therefore, the right to occupy is a right in land and building which can be subject-matter of transfer. It may be that when such a right is transferred, it would be necessary to have the shares also transferred by applying to the society. Even when share is only transferred what is in substance transferred is the right to occupy. Transfer of shares in the context of housing co-operative society is only a matter involving a procedural formality while the substance of the transaction is that of a transfer of a right to occupy the flat - *Ramesh Himmatlal Shah v. Harsukh Jadhavji Joshi* AIR 1975 SC 1470.

In *CIT v. Premanand Industrial Co-operative Service Society Ltd.* [1980] 124 ITR 772, the Gujarat High Court held that in a tenant co-partnership housing society a member has an interest in the property, namely, the flat which is allotted to him or the superstructure which is allotted to him and any such interest is transferable and will be attachable in execution of a decree against a member. Though both the land on which house is constructed and the house itself vest in the society in the eye of law, the transfer of a share in such society is not merely a transfer of share as such but also a right to occupy the house which right necessarily flows from the allotment of the houses by the society to its members. In a tenant co-operative society, share in a society which a member holds is inseparable from his interest in the immovable pro- perty which has been allotted to him for his occupation and enjoyment.

'Transfer' in section 2(47) of the Indian Income-tax Act, therefore, covers every possible mode of 'transfer' where some consideration is involved, *viz.*, sale, exchange, long-term lease, allowing possession of property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, transfer of shares in a company, society or association of persons where holding of such shares is inextricably associated with allotment of flats/houses or any arrangement or agreement which has the effect of transferring, or enabling the enjoyment of such property. Transfer in a normal sense and as understood with reference to the Transfer of Property Act connotes a movement of property or interest or right therein or thereto from one person to another *in praesenti*. But the language of sub-clause (vi) of section 2(47) seems to go further. It, *inter alia* deems doing an act which has the effect of transferring or enabling the enjoyment of any rights in or with respect of any land or any building or a part of the building constructed or to be constructed or in existence as transfer. In the transaction contemplated by this section, one can hardly, trace the movement of property for there is only reduction of a person's exclusive right involving no movement of property. A benefit is however, created in favour of the

persons benefited by it. Instances for such 'transactions' may be many, such as a partner bringing in property as his contribution of the capital of the firm, a Hindu male coparcener throwing his property in his family hotchpot, family arrangement and so on. In none of these there is a movement of property but there is reduction of a right and creation of a benefit thereby which is statutorily deemed to be transfer. Each such concept has been discussed in detail in the following paragraphs.

Capital gains - Partner's contribution as capital

19.10 When a partner hands over his property to partnership firm as his contribution to its capital, he cannot be said to have effected a sale or transfer - *CIT v. Hind Construction Ltd.* [1972] [83 ITR 211](#) (SC), *Sunil Siddharthbhai v. CIT* [1985] [156 ITR 509](#) (SC), *CIT v. Janab N. Hyath Batcha Sahib* [1969] [72 ITR 528](#) (Mad.), *Dr. M.C. Kackkar v. CIT* [1973] [92 ITR 87](#) (All.), *CIT v. C.M. Kunhammed* [1974] [94 ITR 179](#) (Ker.); and *CIT v. Abdul Khader Motor & Lorry Service* [1978] [112 ITR 360](#) (Mad.).

But by virtue of definition of 'transfer' in section 2(47) the act of a partner bringing into the stock of the firm property as a part of his contribution towards the capital of the firm, is deemed to be transfer. The act of the partner results in reduction of the exclusive interest in the totality of rights of the original owner into a joint or shared interest with other persons. An exclusive interest in property is a large interest than a share in that property. To the extent to which the exclusive interest is reduced to a shared interest, there is a transfer of interest. Therefore, when a partner brings in his personal asset into the capital of the partnership firm as his contribution to its capital, he reduces his exclusive right in the asset to share rights in it with the other partner of the firm. While he does not lose his rights in the asset altogether, what he enjoys now is an abridged right which cannot be identified with the fullness of the right which he enjoyed in the asset before it entered the partnership capital.

During subsistence of partnership, no partner can deal with any portion of the property of the firm as his own. Nor can he assign his interest in a specific item of the partnership property to any one. Once a partner has brought in capital money or even property including immovable property, he would cease to be its exclusive owner. The property would be the trading asset of the partnership in which all the partners would have interest in proportion to their share in the joint venture of the business of partnership - *Addanki Narayanappa v. Bhaskara Krishanappa* AIR 1966 SC 1300.

Therefore, what is the exclusive interest of a partner in his personal asset is, upon its introduction into the partnership firm as his share to the partnership capital, transformed into an interest shared with the other partners in that asset. *Qua* that asset, there is a shared interest. During the subsistence of partnership, the value of the interest of each partner *qua* that asset cannot be isolated or carved out from the value of the partner's interest in the totality of the partnership asset - *Sunil Siddharthbhai v. CIT* [1985] [156 ITR 509](#) (SC). The act of the partner has the effect of enabling the other person to enjoy the property which he has brought in as his contribution towards the capital. Such an act, therefore, falls within the meaning of the expression 'transfer'.

Under the Indian laws, partnerships are treated distinct from partners. A partner interest in the partnership may be likened to the interest of a shareholder in a company and its transfer to the shareholder transferring the shares. Gains arising from the alienation of such participation are to be dealt with in the same way as shares in a company and taxable only in the State of the residence of the alienator (*see* OECD Commentary, article 13, paragraph 26). Similar treatment has to be given to other associations which are treated distinct from their members.

Capital gains - Partner's receiving property on dissolution of firm

19.11 Where a partner receives property on the dissolution or on his retirement from the firm, he does not do because of sale or transfer but because of mutual adjustment of rights. It is because when a partner retires or a partnership is dissolved, what a partner receives is his share in the partnership. What happens here is that a shared interest in all the assets of the firm is replaced by an exclusive interest of equal value. That is why it has been held in *CIT v. Dewas Cine Corpn.* [1968] [68 ITR 240](#) (SC), *CIT v. Bankey Lal Vaidya* [1971] [79 ITR 594](#) (SC), *Malabar Fisheries & Co. v. CIT* [1979] [120 ITR 49](#) (SC), *CIT v. Nataraj Motor Service* [1972] [86 ITR 109](#) (Ker.) and *CIT v. Mohanbhai Pamabhai* [1973] [91 ITR 393](#) (Guj.) that there is no transfer. It is the realisation of the pre-existing right.

What is contemplated in dissolution is a share of the partner *qua* the net assets of the partnership firm. What happens is that a shared interest in all the assets of the firm is replaced by an exclusive interest in an asset of equal

value. The position is different where a partner brings his personal asset into the partnership firm as his contribution to its capital. In this case an individual asset is the sole subject of consideration and an exclusive interest in it before it enters in the stock of partnership, is reduced on such entry into a shared interest. The partner by his act enables other partners to enjoy the property which the latter could not have done but for the partnership agreement and the former bringing in his property to the stock of the firm. In case of dissolution, the arrangement amongst the partners does not have the effect of enabling a partner to enjoy the property which he had been doing just before the dissolution.

Capital gains - Coparcener throwing property in hotchpot of family

19.12 A Hindu undivided family is not the creature of contract. The doctrine of throwing into the common stock of the family inevitably postulates that the owner of a separate property is the coparcener who has interest in the coparcenary property and desires to blend it with the coparcenary property. It is well settled law that when a coparcener throws his individual property into the common stock or common hotchpot of the Hindu undivided family that property of a member is said to be impressed with the character of the joint family property and thereafter he cannot make a separate claim over the said property - *Rajanikanta Pal v. Jagamohan Pal* AIR 1923 PC 57. There is no transfer of that property from the coparcener to the coparcenary. It becomes joint family property because the coparcener who owned it up till then as his separate property has, by the exercise of his volition impressed it with the character of joint family property, to be held by him thereafter along with other members of the family. It is by this unilateral act that the property becomes the joint family property. The transaction by which the property ceases to be the property of a coparcener and becomes impressed with the character of the coparcenary property, does not itself amount to transfer - *Goli Eswariah v. CGT* [1970] [76 ITR 675](#) (SC).

But transfer, *inter alia*, means doing anything which has the effect of transferring or enabling the enjoyment of such property by other persons. The various modes through which such acts could be done as mentioned in the parenthesis in sub-clause (vi) of section 2(47), are illustrative and not exhaustive. The act of throwing the property into the family hotchpot may not be transfer but surely could enable other members of the family to enjoy the property thus blended. The whole emphasis is upon the act of a person done with the requisite intent as a result whereof there is transfer of value from any property of that person to a property of another person or to enable that another person to enjoy it as a matter of right. In order to involve hypothetical situation, the two facts should exist, namely (i) the existence of property or a right therein; and (ii) the act on the part of the owner to enable others to enjoy such property or interest therein as a matter of right. When these two facts concur, the hypothesis goes into action and the hypothesis is that these facts are equivalent to transfer made by the coparcener in favour of the persons who are enabled to enjoy the property. Thus, when a person throws his private property into the joint family hotchpot, the property becomes the property of the family with the following incidents :

- ◆ The lineal male descendants upto third generation acquire an independent right of ownership
- ◆ The members of the coparcenary have the right to work out their rights by demanding partition
- ◆ Until partition each member has got ownership extending over the entire property conjointly with the rest
- ◆ As a result of such co-ownership the possession and enjoyment of the property is common.

Thus, an act of throwing property into the hotchpot of the family is deemed to transfer within the meaning of section 2(47).

Partition of the Hindu undivided family properties is merely a process in and by which joint enjoyment is transferred into an enjoyment in severally. Since in such case each one of the coparceners has an antecedent title which extends to the whole of the joint family properties and, has, therefore, full interest in the specific property which ultimately goes to his share, no creation of right or interest in such specific property takes place in his favour nor does any extinguishment of any right or interest in the other property take place to his detriment. The mere fact that on partition a coparcener takes a lesser share than he could have demanded does not mean that there is a transfer in the strict sense - *CED v. Kancharla Kesava Rao* [1973] [89 ITR 261](#) (SC). In partition, whether equal or unequal, there is no transfer by a coparcener in favour of another. Unequal divisions of property knowingly made may not spell invalidity and mathematical equality may not be maintained always in a partition. But the question is whether a willing, *albeit bona fide* arrangement whereby a substantially reduced share is taken by a coparcener vesting a proportionately larger share in the recipient is an arrangement falling within the ambit of sub-clause (vi)

of section 2(47). The answer to this question is in the affirmative, for this has the effect of transferring to or enabling the other person enjoyment of the property.

Capital gains - Family arrangementCapital gains - Family arrangement

19.13 A family arrangement or compromise is not a transfer of property as it does not convey any new distinct title to any of the parties. Each party takes a share in the property by virtue of independent title which is admitted to that extent by the other parties. It is not necessary that every party taking benefit under a family settlement must necessarily be shown to have, under the law, a claim to a share in the property. All that is necessary is that the parties must be related to one another in some way and have a possible claim to the property or a claim or even a semblance of a claim on some other ground as say affection - *Ram Charan Das v. Girja Nandini Devi* AIR 1966 SC 323. The Supreme Court in *Sahu Madho Das v. Mukand Ram* AIR 1955 SC 481 held that a family arrangement is based on the assumption that there is an antecedent title for some sort in the parties and that the arrangement acknowledges and defines what the title is each party relinquishing all claims to that property other than that falling to his share and recognising the right of others to the portions allotted to them. Such an arrangement is intended to avoid future dispute and bring about harmony among the parties - *CGT v. Pappathi Anni* [1981] [127 ITR 655](#) (Mad.). The family arrangement tantamounts to partition of the Hindu undivided family - *CIT v. Narain Dass Wadhwa* [1980] [123 ITR 281](#) (Punj. & Har.). The concept of transfer within the meaning of section 2(47) applies in the same manner as it does when partition of the Hindu undivided family properties are made (discussed in the preceding para).

Capital gains - ReleaseCapital gains - Release

19.14 Release can be usefully employed as a form of conveyance by one person having some right or interest to another having a limited estate, e.g., by a remainderman to a tenant for life, and the release then operates as an enlargement of the limited estate. Thus, the act of release is transfer. Extinguishment of a right may also cover the release of his interest by one joint tenant in favour of another.

Capital gains - DisclaimerCapital gains - Disclaimer

19.15 A disclaimer is an extinguishment of a right. Although in the event of a person disclaiming may not have any right in the property, he may have the right to detain it. This inchoate right is also a right. The word 'right' is a word of widest import. The words 'which has the effect of transferring or enabling the enjoyment of such property' in substance do not necessitate a conscious intention to benefit some person. It is sufficient that some person in fact is benefited. The motive or the purpose of the person is immaterial, provided the transaction does in fact benefit the other person.

Capital gains - Distribution of assets in liquidation of a companyCapital gains - Distribution of assets in liquidation of a company

19.16 When a shareholder receives assets in specie or cash representing his share on distribution of the net assets of the company in liquidation, there is no transfer inasmuch as he receives asset in satisfaction of the right which belongs to him by virtue of his holding shares and not by operation of any transaction which amounts to transfer - *CIT v. Madurai Mills Co. Ltd.* [1973] [89 ITR 45](#) (SC), *CIT v. R.M. Amin* [1977] [106 ITR 368](#) (SC) and *CIT v. Master Raghuvier Trust* [1985] [151 ITR 368](#) (Kar.). This article, however, does not prevent the State of which the company is resident, to tax the difference between the amount received by the shareholder and the par value of the shares, as an income representing distribution of accumulated profits, by virtue of article 10. The Income-tax Act deems such distribution as dividend.

Paragraph 31 of the OECD Commentary on Article 13 also provides similarly. It states :

"If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and the par value of the shares may be treated in the State of which the company is resident as a distribution of accumulated profits and not as a capital gain. The Article does not prevent the State of residence of the company from taxing such distribution at the rates provided in Article 10 : such taxation is permitted because such difference is covered by the definition of the term "dividend" contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the Commentary relating thereto. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in

the State of source of the interest and in accordance with Article 11 (cf. Also paragraphs 20 and 21 of the commentary on Article 11)."

Capital gains - Redemption of bonds

19.17 Redemption of bonds or debentures is not taxable as capital gains, and if on such redemption the amount obtained exceeds the par value of bond or debenture the excess represents interest as it is referable to indebtedness. The excess amount, therefore, be subjected to tax in the source State as interest, in accordance with article 11.

Capital gains - Amalgamation of companies

19.18 A question may arise whether on amalgamation of companies transfer of asset is involved, so that capital gains could be charged.

Amalgamation is a blending of two or more existing undertaking into one undertaking, the shareholders of each blending company becoming substantially shareholders in the company which is to carry on the blended undertakings. There may be amalgamation either by the transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing company. Strictly amalgamation does not, it seems, cover the mere requisition by a company of the share capital of other companies which remain in existence and continue their undertakings but the context in which the term is used may show that it is intended to include such acquisition - *Halbury's Laws of England*, Fourth Edn. Vol. 7, at p. 153. In India, however, no capital gains tax is charged as a consequence of amalgamation, under certain conditions.

Capital gains alienation of property - Permanent establishment

19.19 Paragraph 2 of article 13 deals with alienation of movable property forming part of the business property of a permanent establishment or pertaining to a fixed base. It also deals with the alienation of the permanent establishment or the fixed base. Gains arising from such alienation may be taxed in the state where such establishment or fixed base is situated. The disposal of the movable property is normally taxable in the state of residence of its owner. But when it forms part of the permanent establishment or pertains to the fixed base, it is taxable in the source state. If it does not form part or so pertain, it is not taxable in that state. The doctrine of "Force of attraction" is not applicable, unlike business profit under article 7. Paragraph 2 does not favour the doctrine in relation to capital gains.

It merely provides for the taxability of gain from the alienation of movable property forming part of the business property of a permanent establishment. Gains from the alienation of all other movable are taxable in the State of residence of the alienator as provided in paragraph 6 of the Convention.

Paragraph 2 deals with alienation of movable property of permanent establishment as well as alienation of permanent establishment itself. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property. For the transfer of an asset from a permanent establishment in one State to the head office of the enterprise or the permanent establishment, in another State, capital gain or business profit which may be deemed to arise in connection with such transfer may be subjected to tax (*see* paragraph 10 of the OECD Commentary on Article 13)

Thus, rules of paragraph 2 are applicable—

- when movable property of permanent establishment is alienated (OECD Commentary, paragraph 25);
- when the permanent establishment as such is alienated, with the whole enterprise or alone. If with the whole enterprise, gains which are deemed to result from the alienation of the movable property forming part of the business property of the permanent establishment are subject to rules of paragraph 2 (OECD Commentary, paragraph 25);
- when an asset from a permanent establishment to head office or another permanent establishment in another State is alienated (OECD Commentary, paragraph 10)

If a sale is made of the whole concern and no part of the agreed price is indicated against different items and definite items having regard to their valuation on the date of sale, the agreed price cannot be apportioned to the capital asset is specie. What is sold in such a case is not the individual items of the property forming part of the aggregate, but the capital asset consisting of business of the whole concern or undertaking. Thus, when a business undertaking as a whole is transferred with all its assets, what arises for consideration for the point of view of

taxation is only gains in respect of the transaction and nothing else - *CIT v. Mugneeram Bangur & Co. (Land Department)* [1965] [57 ITR 299](#) (SC). The business undertaking itself is a capital asset - *Syndicate Bank Ltd. v. Addl. CIT* [1985] [155 ITR 681](#) (Kar.).

Capital gains - Movable property Capital gains - Movable property

19.19-1 Paragraph 2 deals with "movable property forming part of the business property of a permanent establishment". The expression "movable property" has not been defined. It may mean property other than the immovable property referred to in Article 6 and dealt with in paragraph 1 of Article 13. It includes also incorporeal property, such as goodwill, licences etc.

Capital gains alienation - Ships or aircraft Capital gains alienation - Ships or aircraft

19.20 Paragraph 3 is a sort of proviso to paragraph 2, carving out an exception. It overrides paragraph 2. It is an extension of the rules contained in article 8 for taxing income from the business of shipping, inland waterways and air transport providing taxation of income in the state where the effective management of the enterprise is situated. In fact the location of the place of effective management determines the state which has the right to tax income from the operation of ships or aircraft, whether such income represent profit (article 8), or capital gain (article 13), or whether taxation is on capital (article 22). Effective management may not coincide with its residence. It may be aboard a ship.

In that case, the place of effective management is the State in which the home harbour of the ship or boat is situated and in its absence the State of which the operator of ship or boat is resident (*see* paragraph 3 of the Model Convention). The OECD Commentary suggests that the Contracting States may in bilateral conventions may confer exclusive taxing right on the State of residence or the primary rights to the State of effective management and the State of residence eliminates double taxation (*see* OECD Commentary, article 13, paragraph 28 read with paragraphs 2 and 3 of the Commentary on article 8).

Where the enterprise does not operate itself the boats, ships or aircraft, paragraph 2 or 5 (OECD Model Convention) applies and not paragraph 3 (*see* OECD Commentary, article 3, paragraph 28.1)

Capital gains alienation - Shares Capital gains alienation - Shares

19.21 Paragraph 4 is an extension of paragraph 1. It is designed to forestall the prevention of the taxability of the gains by the source country, arising from the alienation of immovable property of a company through the incorporation of that company in other State or otherwise. It, therefore, provides that gains on sale of shares of a company, the property of which consists principally of immovable property situated in a Contracting State be taxed by the State in which such property is situated. This para becomes applicable regardless of whether the company or the shareholder is a resident of the Contracting State in which the immovable property is situated or a resident of another State; such a share is deemed to be immovable property. Shares of only those companies the property of which principally constitutes immovable property situated in a Contracting State, are the subject-matter of this article. If the immovable property in that State is only one of various properties of the company; and not the sole or the principal property, the alienation of its shares will not attract this article.

The expression "principally" in relation to ownership of immovable property has now been defined to mean the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership trust or estate.

The Indo-Mauritius and Indo-Singapore treaty, however, provides that capital gain arising from alienation of shares of a company is taxable in the State of alienator irrespective of property of the company principally consisting of immovable property located in another State.

Paragraph may not apply to—

- gains derived from the alienation of shares of companies that are listed on an approved stock exchange of one of the States;
- gains derived from the alienation of shares in the course of corporate reorganization;
- gains derived from the alienation of shares which derive their value from the immovable property (such as mine or a hotel) in which business is carried on (*see* OECD Commentary, article 13, paragraph 28.7); or
- gains derived from the alienation of shares of pension funds and similar entities (*see* OECD Commentary, paragraph 28.8).

Capital gains - Alienation of interest in partnership, trusts owning immovable property

19.22 Similarly interest of a partner in a partnership firm or of a beneficiary in a trust, the property of which consists principally of immovable property, situated in a State is deemed to be immovable property and its alienation giving rise to capital gains is subject to tax of the State which is the situs of the property, regardless of whether the firm or its partners, or the trust or its beneficiaries are residents of another State - *See* agreement with Kenya. This has now been provided in the Model Convention.

Capital gains - shares of company, partnership, trust or estate - exception

19.22A Gains from the alienation of share of the capital stock of the company, partnership, trust or estate are to be taxed (as discussed in the preceding paragraphs) only if such an entity is engaged in the management of the said immovable properties. These are not to be so taxed if the immovable property is used by such entity in its business activities.

Capital gains - Alienation of shares representing substantial participation in a company

19.23 Besides gains from alienation of shares of corporations whose assets are principally immovable property being taxed by the country in which such property is situated, the gains from the alienation of shares of other companies be taxed by the country of which the company is resident if the transaction involves a sale of substantial participation in the company. What percentage would mean substantial participation has been left to the bilateral negotiations. However, in an agreement with Sri Lanka, conditions as alienation of substantial participation or the immovable property being the principal or main assets of the company have been rendered of no relevance. Gains arising from alienation of stock/shares are to be taxed in the Contracting States in which they have been issued. The situs of the share of company is deemed to be in the territory where the company is incorporated - *See* agreements with Finland, Greece and UAR.

Capital gains - Right of alienator State of residence

19.24 Paragraph 6 of Article 13 grants to the State of alienator the exclusive right to tax gains from the alienation of any property other than that referred to in paragraphs 1 to 5. Thus, the Article deals first gains which may be taxed in the State where the alienated property is situated. For all other capital gains, paragraph 6 gives the right to tax to the State of which the alienator is a resident. For example, gains derived from-

- movable property, other than that described in paragraph 2;
 - debt instruments and various financial instruments, to the extent such income is not otherwise characterised as income taxable under another article, *e.g.*, Article 10 (dividends) or Article 11 (interest);
 - shares, other than those described in paragraphs 4 and 5.
-

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - INDEPENDENT PERSONAL SERVICE

ARTICLE 14

INDEPENDENT PERSONAL SERVICES

1. *Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State :*

(a) if he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or

(b) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

2. *The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.*

IntroductionIntroduction

20.1 Article 14 is one of the series of articles which deal with taxation of individuals working abroad. An individual can render his personal services as an employee or independently.

The Convention deals in separate articles classes of income from personal services :

- Article 14 - Independent personal services;
- Article 15 - Dependent personal services;
- Article 16 - Director's fees and remuneration of top- level managerial officials;
- Article 17 - Artistes and sportspersons;
- Article 18 - Pensions and social security payments;
- Article 19 - Government service;
- Article 20 - Students.

Article 14 and Article 15 deal with the general class of income, respectively from independent and dependent personal services. All other Articles provide exceptions and additions. The principal consideration in determining whether an individual is an employee (dependent service) or an independent contractor (independent service) is whether or not services performed by an individual are for his own account, whether he receives the income and bears the losses arising for such services. For example, services supplied by an expert consulting engineer fell within the scope of independent service [*see Von der Mark v. CIT* [1999] [235 ITR 698](#) (AAR)].

Income derived by persons other than individuals or groups of individuals from performance of independent personal services is not covered by Article 14. Companies cannot perform personal services (a ruling of German Bundesfinanzhof July 7, 1971, I.R. 41/70). Such income is generally characterised as business profits taxable in accordance with Article 7. Income derived by employees is taxable under Article 15.

The article deals with income arising from the activities of a resident of the Contracting State in another Contracting State, which are in the nature of independent personal services. Personal services are of two types :

- ◆ Independent personal service - business
- ◆ Dependent personal service - employment income

Income derived from the independent personal activity is dealt with in article 14 of the UN Model and dependent personal activity in article 15. However, independent personal entertainers and sports persons are dealt with separately in article 17. This article does not include industrial or commercial activities and also personal services performed in employment. Personal services generally fall to be taxed as trading income. 'Trade' in its primary meaning, is the exchanging of goods for goods or goods for money; in the secondary sense it is repeated activity in the nature of business carried on with a profit motive, the activity being manual or mercantile, as distinguished from liberal arts or learned professions or agriculture.—*State of Punjab v. Bajaj Electricals Ltd.* [1968] 70 ITR 730 (SC). The new trend is veering round trade in services, though services are fundamentally different from other kinds of economic activity. Service is traded as goods, for money; and, therefore, income arising from such trade is taxed on the same rule as the income from the trade in goods. Otherwise also 'business' does not necessarily mean trade or manufacture only, it is being used as including within its scope professions, vocations and callings for a

fairly long time. The word 'business' is of wide import and it means an activity carried on continuously and systematically by a person by the application of his labour and skill with a view to earning income. Therefore, professional activities exercised continuously and systematically with a profit motive generally is to be taxed as if business income. For that purpose the concept of fixed base akin to the concept of permanent establishment becomes necessary for the assessability of income from professional activities.

Paragraph 1 lays down the basic rule and also exceptions. State of residence has the right to tax income derived from the exercise of professional services or other activities of independent character. It may also be taxed in the state of source under exceptional circumstances. Paragraph 2 defines the expression "professional services" inclusively. In fact, the article lays emphasis on the independent status of the person and his professional and other activities of independent character rather than on providing professional services. Professional services can be provided as an employee also. For that purpose, article 15 is relevant.

Independent personal service - State of residence right to tax

20.2 Basically the right to tax income which is derived by a resident in respect of professional and other activities is given to his state. Paragraph 1 so provides. It also provides that other state may also tax if in that state.

- (a) he has fixed base regularly available to him for the purpose of performing his activities; or
- (b) his stay is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year.
- (c) Remuneration for his activity is paid by the resident of that state or is borne by a permanent establishment or fixed base situated there (has since been deleted).

The amount taxable is so much as is attributable to the fixed base, or derived from activities during the stay, or exceeding the limit as is provided in the treaty in case of (c), as the case may be.

The availability of fixed base was the only requirement of the OECD Model before deletion of article 14. The other two requirements [(b) and (c) above] are the additional and alternative requirements of the UN Model. These criteria may be applied independently and separately or in combination before the state of source could impose tax. The last criteria is not generally provided. It is rarely done, so far only two Indian treaties namely, Canada and Zambia. The threshold limit in the Canadian treaty is \$ 2500 and in the Zambian, K 10,000, for the applicability of (c) criterion.

Treaties with Austria and Greece provide that state where the services are rendered may alone tax the income. Fixed base is not the requirement in some other treaties, such as Brazil, Russia, Sri Lanka, Switzerland, UAR.

Independent personal service - Fixed base

20.3 The basic tenet of the article is that a person undertaking professional or other independent activities in a state other than of his residence is liable to be taxed in that state if he has a fixed base there available to him. Such requirement is akin to the requirement of the existence of the permanent establishment for a trading enterprise. The term "fixed base" has not been defined, as the term "permanent establishment" has been done in article 5. It is perhaps not necessary. Its closeness to the expression "permanent establishment" provides a meaning to it. That definition could provide guidelines to determine what the expression "fixed base" may connote. The closeness however, does not suggest that the concept of permanent establishment is extended to the activities which are the subject-matter of article 14. The word "establishment" for trading activity and the word "base" for independent personal service make the difference. Both have to be "fixed", in the sense that they exist for some reasonable period sufficient to establish nexus with the place for carrying business operation or base for carrying the said activities. A place when used for business purposes may be called a shop; but, when used by an advocate or a doctor for his professional work, a chamber or clinic. In the former case it is called "permanent establishment", and in the latter, "fixed base". Thus, what is "permanent establishment" to the business or industrial activity, "fixed base" is to the independent or professional activity. Its existence is the *sine qua non* for the taxability of income by the source state, so much as is attributable to it.

Fixed base-regularly available

20.3-1 The "fixed base" should not only exist but also be regularly available for the purpose of performing of professional and other activities. The expression "regularly available" would generally mean that the fixed base is available at the disposal of the individual whenever he performs services; notwithstanding whether he makes its

use. Regular availability rather than the actual user for performance of service is the requirement. The Technical Explanation on the US Model Convention clarified by an illustration :

"For example, a U.S. resident partner in a law firm that has offices in the other Contracting State would be considered to have a fixed base regularly available to him in the other State if the law firm had an office in the other State that was available to him whenever he wished to conduct business in the other State, regardless of how frequently he conducted business in the other State."

Occasional renting an accommodation in a hotel to serve as a temporary office is not considered fixed base regularly available.

Independent personal service - Stay in the source State (alternative criterion)Independent personal service - Stay in the source State (alternative criterion)

20.4 Presence of the person rendering services in the source state for a minimum period of time is another criterion alternative to fixed base to enable that State to impose tax on the amount as is derived from his activities performed there. Such a criterion is the peculiarity of the UN Model.

Since the 'capital' investment in the production of income from professional services is represented in the special or peculiar intellectual skill and educational qualification, knowledge or experience, and the professed attainments of the person concerned, the continued presence of that person in the host country results in the generation of income. The source State has also a right to levy tax. The UN Model Convention strikes a compromise between the conflicting claims of the residence and the source States. The criterion for such continued presence as provided, besides the availability of the fixed base is the physical presence for a specified period or by the level of earning beyond a certain threshold limit.

Independent Personal Service - Computation of income and doctrine of attributionIndependent Personal Service - Computation of income and doctrine of attribution

20.5 What is subject to tax as income from the exercise of professional activity or similar independent activity is the income attributable to the fixed base or derived from such activity during the stay for the concerned period in that State (*i.e.*, the net income arrived at after deleting expenses from the gross income). If all the operations of a professional activity are carried in a State, the entire income accruing therefrom shall be deemed to have accrued in that State. If, however, all the operations are not so carried on, the income from the exercise or professional service deemed to accrue through or from 'professional connection' in the source state shall only be such income as is reasonably attributable to that part of the activity carried on in that State. *Barendra Prasad Ray v. ITO* [1981] [129 ITR 295](#) (SC). The doctrine of attribution is applicable if the person concerned has a fixed base regularly available to him for the purpose of performing his activities. Regular availability of the fixed base and the performance of service in the other State must be established, before the State could be entitled to levy tax on it. But in case where the person's stay is the basis of taxability, income derived from the activity is taxed by the State, *i.e.*, when the income is obtained or received from exercise of that activity therein. The activity in the State should be the effective source of income, and not that it has contributed indirectly to the arising or its accrual. The computation of income is to be made on the same rule as is applicable for computation of trading or business income. For determination of income as is attributable to the fixed base, the same rule as outlined in article 7 has to be applied. The fixed base is considered an independent entity. If determination is not possible it is done by apportioning the total income on a fair basis.

Taxing right under Article 14 is more limited than that provided in Article 7. In the former, income must be attributable to services performed in the State; in the latter, all income generating activities need not be performed where the permanent establishment is situated. Thus, in the former the doctrine of "force of attraction" is not applicable.

Independent Personal Service - Professional services - Meaning ofIndependent Personal Service - Professional services - Meaning of

20.6 Article 14 deals with what are commonly known as professional services [such as those relating to scientific, literary, artistic or teaching activities] and with other activities of independent character [such as activities of physicians, lawyers, engineers, architects and accountants]. This does not include industrial and commercial activities, and also professional services performed in employment. The term has not been defined exhaustively.

Some illustrative examples have been given to suggest what this expression could mean. These relate to typical liberal profession. The definition, as given in paragraph 2 of article 14, is inclusive.

The word 'profession' involves the idea of an occupation requiring either purely intellectual skill, or of manual skill controlled, as in painting and sculpture, or surgery, by the intellectual skill of the operator, as distinguished from an occupation which is substantially the producing or sale or arrangements for the production or sale of commodities. The line of demarcation may vary from time to time. The word 'profession' which was used to be confined to the three learned professions, the Church, Medicine and Law has now a wider meaning—*Commissioners of Inland Revenue v. Maxse* [1919] 1 KB 647. It now also implies professed attainments, in special knowledge as distinguished from mere skill; a practical dealing with affairs as distinguished from mere study or investigation and an application of such knowledge to uses of others as a vocation, as distinguished from its pursuit for its own purpose. *M.P. Sethurama Menon v. Meenakshi Amma* AIR 1967 Ker. 88. Thus, professional activity is an activity carried on by an individual by personal skill and intelligence—*Dr. Devendra Surti v. State of Gujarat* AIR 1969 SC 63.

There is a fundamental distinction between an activity of a professional activity and an activity of a commercial character and unless the profession carried on by a person also partakes of the character of a commercial nature, he cannot be said to be engaged in a commercial activity.

The Supreme Court in *V. Sasidharan v. Peter & Karunakar* AIR 1984 SC 1700, observed in the context of a question whether a firm of a lawyer is a commercial establishment within the meaning of the Kerala Shops and Commercial Establishments Act, 1960:

"... Whatever may be the popular conception or misconception regarding the role of today's lawyers and the alleged narrowing of the gap between a profession on the one hand and a trade or business on the other, it is trite that, traditionally, lawyers do not carry on trade or business nor do they render services to 'customers'. The context as well as the phraseology of the definition in section 2(15) is inapposite in the case of a lawyer's office or the office of a firm of lawyers." (p. 1702)

Though under certain circumstances a professional activity is considered to be a business activity as the word "business" is of an ambiguous import and it takes its content from its context, business normally does not include the professional activity—*M.P. Sethurama Menon v. Meenakshi Amma* AIR 1967 Ker. 88.

Independent Personal Service - Activities of Independent character

20.7 The Model Convention refers two kinds of activities, viz., professional services and other activities of independent character. As aforesaid professional activities are those in which professed knowledge of some department of science or learning is used by its partial application to the affairs of others, either in advising, guiding or teaching them or in servicing their interests or welfare in the practice of an art founded on it. It implies professed attainments in special knowledge as distinguished from mere skill. A practical dealing with affairs as distinguished from mere study or investigation; and an application of such knowledge to uses for other as a vocation, as distinguished from its pursuit for its own purposes. The meaning of professional services has been extended by paragraph 2 of article 14 as to include two types of independent activities, namely:

- ◆ Scientific, literary, artistic, educational or teaching activities
- ◆ Independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

There may be many activities other than those aforementioned which could be income generating, undertaken independently. These are also covered by article 14, under the residuary expression 'other activities' of independent character. The word 'other' may mean that activities need not be *ejusdem generis* with the activities mentioned earlier but they must be analogous. The character of the activities is important. These should be of independent in nature. The essence of 'independent character' is that generation of income is dependent mainly upon the personal qualification of the person by whom the activity is undertaken and that can only be the individual, that is, the activity carried on by an individual by his personal skill and intelligence. The capital he brings in this activity is his special or peculiar intellectual and educational equipment, for the production of income. The activities of professional entertainers, sports persons, film, radio, T.V. artists, musicians and such other activities are analogous to the aforementioned professional activities. But for such activities there is a separate article (article 17) dealing with income arising from their exercise. There may be many other activities, besides these, which could be encompassed within the expression 'other activities of an independent character'.

Thus, all personal services, other than those specified in Articles 16 to 20 performed by an individual for his own account where he receives the income and bears the risk of loss arising from this services, are covered.

Some of the Indian agreements (for example, Finland, Hungary, Indonesia, Mauritius) use the expression 'other independent activities of a similar character'. The word 'similar' refers to akinness with the character of the activities which the 'professional services' bears, though it is not synonymous with 'same'. An activity could be similar without its being a slavish copy of what it is similar. The expression 'similar' does not mean identical but it means corresponding to or resembling to in many respects; somewhat like, or having a general likeness—*Net Steel Equipment (P.) Ltd. v. Collector of Excise* AIR 1988 SC 631. If contents of the activities are almost the same, these could be said similar. Its use gives a wide amplitude as to bring within the purview of article 14, activities of independent character which are analogous to professional services.

Independent personal service - India's approach to tax treaties

20.8 India generally follows the UN Model. Fixed base is the normal requirement (exceptions are Brazil, Greece, Sri Lanka, Russia, UAR). In addition to "fixed base" and as its alternative, Indian treaties prescribe number of days test *i.e.*, the presence of the recipient of income in the source state for a period of 183 days or more in a fiscal year. In some treaties it is 90 days (Czech, Finland, Malta, Russia, Singapore, UK, USA), 91 (Indonesia), 120 (Germany, Sri Lanka). The threshold of remuneration earned in a year, a third test of the UN Model, is not generally followed. India's approach to individual treaty is summarised in the appendix to this chapter.

APPENDIX - INDEPENDENT PERSONAL SERVICE TESTS FOR TAXATION IN THE SOURCE STATE

<i>Country</i>	<i>Fixed base</i>	<i>No. of days</i>	<i>Year</i>	<i>Remuneration test</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(5)</i>
Armenia	Yes	183	Any 12 month period	No
Australia	Yes	183	Fiscal year	No
Austria	Yes	183	12 months	
B'desh	Yes	183	Previous year	No
Belarus	Yes	183	12 months	
Belgium	Yes	183	Previous year	No
Brazil	No	No	-	Yes
Bulgaria	Yes	183	Previous year	Yes
Canada	Yes	183	Fiscal year	Yes (\$ 2,500)
China	Yes	183	Taxable year	No
Cyprus	Yes	183	Fiscal year	No
Czech				
Republic	Yes	183	12 months	

Denmark	Yes	183	Previous year	No
Finland	Yes	90	Fiscal year	No
France	Yes	183	Fiscal year	No
Germany	Yes	120	Fiscal year	No
Greece	No	183	Previous year	Yes
Hungary	Yes	183	Any 12 month period	No
Indonesia	Yes	91	Any 12-month pd	No
Israel	Yes	183	Any 12-month period commencing or ending with fiscal year	No
Ireland	Yes	183	12 months	
Italy	Yes	183	Fiscal year	No
Japan	Yes	183	Previous year	No
Jordan	Yes	183	12 months	Yes (US \$ 2000)
Kazakhstan	Yes	183	Any 12-month period commencing or ending in the fiscal year	No
Kenya	Yes	183	Previous year	No
Korea	Yes	No	No	No
Kyrgyz Republic	Yes	183	12 months	
Libya	Yes	No	No	No
Malaysia	Yes	183	Fiscal year	Yes (US & 2000)
Malta	Yes	90	Fiscal year	No

Mongolia	Yes	183	Fiscal year	No
Mauritius	Yes	No	No	No
Namibia	Yes	183	12 months	
Nepal	Yes	183	Previous year	No
Netherlands	Yes	183	Fiscal year	No
New Zealand	Yes	183	Any consecutive	No
				12 - month period
Norway	Yes	183	Any two consecutive years of income	No
Oman	Yes	183	Fiscal year	No
Philippines	Yes	183	Previous year	No
Poland	Yes	183	Previous year	No
Portugal	Yes	183	12 months	
Qatar	Yes	183	12 months	
Romania	Yes	183	Previous year	No
Russia	No	90	Fiscal year	No
Singapore	Yes	90	Fiscal year	No
Slovenia	Yes	183	Any 12 month period	No
South Africa	Yes	183	Any 12-month period commencing or ending in fiscal year	No
Spain	Yes	183	Taxable year	No
Sri Lanka	No	120	Any 12-month	No

			period	
Sudan	Yes	183	-do-	No
Sweden	Yes	183	Any 12-month period commencing or ending in fiscal year	No
Switzerland	No (No separate article)	183	Fiscal year	Yes
Syria	Yes	183	Previous year	No
Tanzania	Yes	183	Year of income	No
Thailand	(Yes for or more than 183 days in previous year)	183	Previous year	Yes
Trinidad and Tobago	Yes	183	12 months	
Turkey	Yes	183	Previous Year	No
Turkmenistan	Yes	183	Any 12-month period commencing or ending in the fiscal year	No
UAE	Yes	183	Fiscal year	No
UAR	No	183	Fiscal year	No
UK	Yes	90	Fiscal year	No

USA	Yes	90	Fiscal year	No
Uganda	Yes	183	12 month period	No
Ukraine	Yes	183	Fiscal year	
Uzbekistan	Yes	183	Fiscal year	No
Vietnam	Yes	183	Fiscal year	No
Zambia	Yes	183	Previous year	Yes (K 10,000)

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - DEPENDENT PERSONAL SERVICE

ARTICLE 15

DEPENDENT PERSONAL SERVICES

1. Subject to the provisions of articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

- (a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned; and*
- (b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and*
- (c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.*

3. Notwithstanding the preceding provisions of this article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Introduction

21.1 Income from employment (salaries) is dealt with in article 15. Exceptions are director's fee (article 16), pensions (article 18), and remuneration from Government service (article 19). Paragraph 1 lays down a principle that income is taxable in the state of which the person is resident. Exception is the place of exercise of employment. It is then taxable in that state. It is the basic position. But if an employee spends a short period abroad *i.e.*, a period less than 183 days, and remuneration is paid by an employer who is not a resident of that state and is not borne by a permanent establishment or the fixed base which the employer has in that state, it is taxable in the state of his residence. In case employment is exercised aboard a ship or aircraft operated in international traffic, the income is taxable in the Contracting State in which the place of effective management of the enterprise is situated (paragraph 3). The crux of the article is to determine the place where the employment is exercised. After having so determined, it is to find out whether the case falls under paragraph 2. If it does, income is taxable in the state of

residence. If it falls under paragraph 3, it is taxable in the state in which the effective management of the enterprise is situated.

Salary - Taxable in the State where employment is exercised

21.2 Paragraph 1 of article 15 enunciates the basic principle about the taxability of income derived by a person as salary, wages and other remuneration in respect of an employment. It is taxed in the state of his residence. If the employment is exercised (*i.e.*, service performed) in another state, it is taxed there. The location of income from employment is where the taxpayer performs his duties of employment since it is the performance of such duty which produces the employment income - *FCT v. French* 11 ATD 288. This principle has been incorporated in section 9(1)(ii) of the Indian Income-tax Act, 1961. If salary is earned in India, it is deemed to arise in India. Thus, where an employee carries out his duties in India, the salary received by him is taxable in India irrespective of the place of payment or of the contract or of his residential status. The question where employment is exercised requires examination of the concept of employment. It also requires consideration what the expressions "salary", "wages", and "other similar remuneration" mean as the taxability of the amount thus received is subjected to tax.

Paragraph 1 establishes the general rule that income from employment is taxable in the State where employment is actually exercised. It is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid (*see* OECD Commentary on Article 5, paragraph 1).

Employment - Meaning and ingredients

21.2-1 In Chamber's 20th Century Dictionary, "employ" has been indicated to mean to occupy the time or attention of "Employment" means an act of employing. In the *Concise Oxford Dictionary*, "employee" means a person employed for wages. Employment normally means the state of condition of a person who provides services to another for reward; it may sometimes mean the appointment or engagement of a person, but that meaning is rare - *Shilton v. Wilmshurst* [1990] 1 WLR 373, [1991] 187 ITR 163 (CA), as per Staughton L.J. "Employ" thus means use of services of persons. It comprehends a whole-time or a part-time of engagee - *CBDT v. Aditya V. Birla* [1988] [170 ITR 137](#) (SC). The amplitude of the expression "employee" and "employer" covers cases of consultant or a technician. Remuneration received from an employer cannot be confined only to salary received by him though it is generally be so taken.

The concept of employment involves three ingredients, *viz.* (a) employer, (b) employee, and (c) contract of employment. The employer is one who employs, *i.e.*, one who engages the service of other persons. The employee is one who works for another for wages. The employment is the contract for service between the employer and the employee where under the employee agrees to serve the employer subject to his control and supervision. The test which is uniformly applied to determine the existence of relationship of employer and employee is whether the employer has the right to control in respect of the manner in which the work is to be done. The four indices for service are the following - *Short v. Henderson* [1946] 62 ILR 427 and *Piyare Lal Adishwar Lal v. CIT* [1960] [40 ITR 17](#) (SC):

- The master's power of selection of his servant;
- The payment of wages or other remuneration;
- The master's right to control the method of doing the work;
- The master's right of suspension or dismissal;

The master's right to control the method of doing the work is the decisive element in the relationship.

Such rights as mentioned above suggest that the ultimate responsibility relating to work rests upon the master. He has the rights in the work being done, has the responsibility or risks for the results produced by the employee's work.

Paragraph 8 of the OECD Commentary on Article 15, interpreted the term "employer" in the context of paragraph 2 of that Article to mean as "the person having rights on the work produced and bearing the relative responsibility and risks." That interpretation is relevant for the whole Article as also all provisions of the Convention.

Employment - agreement to retain and pay

21.2-2 The expression "to employ" has been considered in *Ellis v. Joseph Ellis & Co.* [1905] 1 KB 324 (CA). It does not mean generally to find actual employment; it rather means to retain and pay a person whether employed or not but if employed then to be employed in the work only in respect of which the contract is made. Medical

advisers may be employed at a salary to be ready in case of illness; members of theatrical establishments, in case their labour should be needed; household servants in the performance of a duty when their masters in wish. In these and similar cases, the requirement of actual service is distinct from the employment by the party employing. In an agreement to "retain and employ", "employ" means only to "retain" in the service "and is mere tautology". The expression, however, must depend upon the context of the particular provision in which it appears. It was held in England that an engineer appointed by a local authority to supervise the execution of works but not subject to local authority's supervision, is nevertheless an employee within the meaning of section 40(1) of the Local Government Superannuation Act, 1937 - *Morren v. Swinton & Pendlebury Borough Council* [1965] 1 WLR 576 (QB).

Employment - Contract for or of service

21.2-3 There is a distinction between a contract for service and a contract of service which can be put in this way: "In the one case the master can order or require what is to be done while in another case he cannot only order or require what is to be done but also how itself it shall all be done" - *Dharangadhra Chemicals Works Ltd. v. State of Saurashtra* [1957] SCR 152. The nature and the extent of control which is requisite to establish the relationship of an employer and employee must necessarily vary from business to business and by its very nature incapable of precise definition. It is not necessary for holding a person employee that the employer should be proved to have exercised control over his work, that the test of control is not of universal application and that there are many contracts in which the master cannot control the manner in which it is to be done. The correct method of approach, therefore, would be to consider whether having regard to the nature of the work there was due control and supervision by the employer or to use the words of Fletcher Moulton L.J. in *Simmons v. Health Laundry Co.* [1910] 1 KB 543: "The question of amount of direct control exercised over the person rendering the services by the person contracting for them the stronger the grounds for holding it to be a contract of service and similarly the greater the degree of independence of such control the greater the probability that services rendered are of the nature of professional services and that the control is not one of services - *CWT v. V.O. Ramalingam* [1995] [216 ITR 566](#) (Mad.) and *CIT v. Manmohan Das* [1966] [59 ITR 699](#) (SC).

Employment - Agent and servant distinguished

21.2-4 An agent is to be distinguished on the one hand from a servant and on the other from an independent contractor. A servant acts under the direct control and supervision of his master and is bound to conform to all reasonable orders given to him in the course of his work. An independent contractor, on the other hand, is entirely independent of any control or interference. He merely undertakes to produce a specified result employing his own means to produce that result. An agent, though bound to exercise his authority in accordance with all lawful instructions which may be given to him from time to time by his principal, is not subject to direct control supervision. An agent as such is not a servant. But the converse may not be true. A servant may for certain purposes be his master's implied agent. The extent depends upon the duties or his position. Whether a person is a servant or an agent, the test is whether under the terms and conditions a supervisory control is exercised by the employer in respect of the entrusted work. But this test is not universal in its application. In determining the relationship, due regard must be had to the nature of the particular business, the terms of the engagement and the nature of the duties to be performed by the person in respect of whom the question has arisen as to whether he is an employee - *CIT v. Travancore Chemical Mfg. Co.* [1982] [133 ITR 818](#) (Ker.)

Employment - Director whether employee

21.2-5 The aforesaid principles could well be applied in case of a director of a company. He may have a dual capacity. In the capacity of the managing director he may be regarded as having not only the capacity as persona of a director but also has the persona of an employee or an agent depending upon the nature of the work and the terms of his employment. Where he is so employed, his relationship with the company is similar to a person employed as servant or agent. The nature of employment may be determined by the articles of association of the company and/or the agreement with the company. However, as regard director's remuneration there is a specific provision (article 16).

Salary, wages and other similar remuneration

21.3 What is subject-matter of article 15 is the salary, wages and other similar remuneration derived by a person in respect of employment.

Salary - Meaning

21.3-1 "Salary" according to the *Shorter Oxford Dictionary* means: "To recompense, reward, to pay something due". In Jowitt's *Dictionary of English Law*, "salary" is explained as "recompense or consideration, generally periodically, made to a person for his service in another person's business; also wages, stipends or annual allowance". In *Stroud's Judicial Dictionary*, the expression "salary" is explained as where the engagement is for a period, is permanent and substantially permanent in character and is for other than manual or unskilled labour, the remuneration is generally called "salary". According to the *Indian Income-tax Act*, all payments made to the holder of an office or employment is treated as salary. If the payment has to be regarded as salary, it must be due from an employer and the person making it does it in his capacity as an employer. Thus payment must be related to the employment.

Wage - Meaning

21.3-2 Conceptually there is no difference between salary and wages, both being a recompense for the work done or services rendered, though ordinarily the former expression is used in connection with services of non-manual type while the latter is used in connection with manual services. In fact, in the case of salary, the recompense could be determined wholly on the basis of time spent on service or wholly by the work done or partly by the time spent in service or partly by the work done. In other words, whatever be the basis on which the recompense is determined it would be salary - *Gestetner Duplicators (P.) Ltd. v. CIT* [1979] 117 ITR 1 (SC).

Other similar remuneration

21.3-3 Remuneration ordinarily means reward, recompense, pay, wages or salary for services rendered - *Accountant - General v. N. Bakshi* AIR 1962 SC 505. It is a term of wider import than "wages" and includes "recompense", "reward" or "payment" - *CIT v. Calcutta Stock Exchange Association Ltd.* [1959] [36 ITR 222](#) (SC) "Emoluments from employment" means as emolument from "being or becoming an employee" - *Shilton v. Wilmshurst* [1991] 191 ITR 614 HL. It is a sum paid by an employer to an employee qua the employee for something done as an employee - *V.R. Ganti v. CIT* [1995] [216 ITR 48](#) (AP). The word "other" when following an enumeration must receive an ejusdem generis interpretation and in this context may mean the recompense for services rendered partaking of the character of salary or wages. The use of the word "similar" reinforces this interpretation.

Paragraph 2.1 of the OECD Commentary on Article 5 clarified :

"Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g., the use of a residence or automobile, health or life insurance coverage and club memberships)"

Other remuneration - Employees' Stock Option

21.3-4 To provide remuneration and incentives to employees, a company may give option to them to subscribe to its shares at a predetermined price called the option price which is lower than the ruling market price of the shares. The employees have the option to subscribe and become the owners of the shares on the date of their choice. The purpose of the Stock Option Plan or Scheme is to attract and retain the best available personnel for positions of substantial responsibility, to provide additional incentive to such individuals, and to promote the success of the company's business by aligning employees with financial interests with long-term shareholder value.

The taxability of the amount to be gained by the exercise of the option cannot be in doubt. It is a perquisite or profit arising out of employment. The only question is of characterisation: employment income or capital gain or at what point of time the remuneration (employment income) turns into capital gains. The timing of taxation depends upon how it is characterised. If it is assessed under the head "Salaries" it could be the date of grant or the date of vesting or exercise of option. If done under the head "Capital gains", it is the date of sale. The *Authority for Advance Rulings in P. No. 15 of 1998* [1999] [235 ITR 565](#) (AAR) held :—

"The employees, in the present case, are going to receive something in addition to their salary and wages. The stock option scheme will enable them to get something in addition to their remuneration . This addition will clearly come within the definition of the expression 'Salaries'."

The Indian Income-tax Act, 1961 had also so provided. But with effect from 1-4-2001, the income cannot be assessed under the head "Salaries". The following proviso inserted to sub-clause (iii) of section 17(2) (which section inclusively defines the expression "perquisite") by the Finance Act, 2000, with effect from 1-4-2001 makes it clear:—

"Provided that nothing contained in this sub-clause shall apply to the value any benefit provided by a company free of cost or at a concessional rate to its employees by way of allotment of shares, debentures or warrants directly or indirectly under the Employees Stock Option Plan or Scheme of the said company".

Lord Denning in his dissenting judgment in *Abbot v. Philbin (Inspector of Taxes)* [1960] 2 All ER 363 (quoted in P.No. 15 of 1998 [1999] [235 ITR 565](#) (AAR)) held that mere receipt of the option was not taxable. He observed :

"the expectation of receiving a benefit, no matter how well founded, is not itself a perquisite or profit. It must be reduced into possession. A bird in hand is taxable, but a bird in the bush is not."

In India, the option is not taxable under the head "Salaries". It is taxable as capital gain. In other countries, it may be taxed as salary. The Indian and other country rules governing the timing and the characterisation of income arising from stock option may result in an explicit potential for double taxation or non-taxation.

Salary - Taxable in the residence State even if employment is exercised in another state

21.4 Paragraph 2 contains a general exception to the rule in paragraph 1 that employment income may be taxed in the State where it is exercised. This exception covers all individuals rendering services in the course of employment (sales representatives, construction workers, engineers, etc.) to the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen (*see* paragraph 3 of the OECD Commentary on Article 15).

A reading of paragraph 1 indicates that the primary taxing right is given to the State where the employment is exercised which could be denied and given to the State of residence under exceptional circumstances as provided in paragraph 2, a negative list of three. If any of that negative list is found existing, the State of employment loses jurisdiction. All the three conditions must, therefore, be satisfied. If satisfaction fails, only the State of residence has the right to tax. The satisfaction requirement should be complete, *i.e.*, all should be satisfied and failure in regard to any would render paragraph 2 inapplicable and disable the State of employment to exercise jurisdiction. These are :—

- (a) The recipient is present in the State (where employment is exercised) for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in any fiscal year concerned;
- (b) The remuneration is paid by, or on behalf of, an employer who is not a resident of that State;
- (c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in that State.

(These conditions are discussed individually later).

Two factors decide the question: one, the period of physical presence of the person in the State of employment being not more than 183 days ; and second, remuneration having been paid by the employer who is not resident of, or borne by his PE in, that State. If the period is shorter than of 183 days, income is not taxable in the State of employment. Even if longer, it is also not taxable if the employer who paid the remuneration is not resident of, nor has he a permanent establishment/fixed base in, that State. In other words, if the remuneration is paid by the employer who is resident of that State or borne by his PE in that State, the "183-day" condition does not apply, *i.e.*, remuneration would be taxable in that State if the duration of the stay is more than 183 days. Thus, a question has first to be asked whether the employer is resident of, or has PE in, the State in which the employment is exercised and the remuneration is paid by him or borne by the PE and another question whether the stay exceeds 183 days. If yes, remuneration will be taxable in that State.

The order of the questions may be reversed. First, whether the person was present in the State of employment for a period of more than 183 days and if the answer is yes, then another question whether the employer is resident of that State (who pays or on whose behalf remuneration is paid) or has a permanent establishment/fixed base in that State which bears the remuneration, and if again the answer is yes, then remuneration is taxable in the State of employment; otherwise in the State of residence. Negative answer to either of the questions results in denial to the State of employment and consequently in conferring to the State of residence jurisdiction to tax. Thus, if the employer who pays the remuneration is resident of the State of employment or has a permanent establishment/fixed base in that State which bears it, but the stay of the employee is shorter than 183 days, or if the stay is longer but the employer is not the resident of nor has be permanent establishment/fixed base, the State of employment has no jurisdiction.

There is a provision under the Indian Income-tax, Act, 1961, almost similar to paragraph 2 of article 15, where the requirement of stay is limited to 90 instead of 180 days (discussed in paragraph 21.5, below). Section 10(6)(vi) exempts from tax the remuneration by an employee of a foreign enterprise for his services rendered in India provided three conditions are satisfied, which correspond to the three conditions of article 15(2), *i.e.*, (i) the employer is not engaged in any trade or business in India (corresponding to condition (b) of article 15(2), the employer being resident of the State of employment), (ii) his stay in India does not exceeds ninety days (corresponding to (a) requiring stay should not exceed 183 days), and, (iii) remuneration not liable to deduction chargeable under the Indian Income-tax Act, 1961 (corresponding to (c), remuneration borne by employer permanent establishment/fixed base). If the provisions of article 15(2) are juxtaposed with those of the Indian Income-tax Act and read, it would be clear that the income is not taxable in the State of employment if the person's stay does not exceed 183 days, and the employer is not the resident of, nor has a permanent establishment which bears the remuneration, in that State. In other words, income is taxable in the State of employment if the person is present in that State for a period exceeding 183 days and the remuneration is paid by an employer who is resident of that State or is borne by a permanent establishment or a fixed base which the employer has in that State.

A reference to an analogical provision of article 14 of the UN Model Convention makes the position clear. That article deals with independent personal service while article 15 with dependent personal service. Both deal with personal service, one independent and the other dependent. Article 14(1)(b) and (c) (which has now been omitted) is not couched in negative terms as article 15(2). Those provisions provide that income of a person would be taxable in the State in which independent personal service is exercised—

- ◆ If his stay in that State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned ; and
- ◆ Remuneration for his activity is paid by the resident of that State or is borne by the permanent establishment or fixed base.

Article 14 and article 15 deal with general class of income of an individual, respectively from independent and dependent personal services. The above conditions relating to independent personal services can guide how the conditions set out in article 15(2) which are couched in negative terms could be read.

From the above discussion, it is clear that that State where the employment is exercised has the jurisdiction to tax, under article 15(2) :

- ◆ If the person is present in that State for a period more than 183 days; and
- ◆ Remuneration is paid by the employer who is resident of that State or is borne by the permanent establishment which the employer has in that State.

Period of 183 days - physical presence test

21.4-1 The first condition is that the exemption is limited to the 183 days period. OECD Model Convention stipulates that this time period may not be exceeded "in any twelve month period commencing or ending in the fiscal year concerned".

The 183-day period is to be measured using the "days of physical presence". Under this method, the days that are counted include any day in which part of the day is spent in the host country (Rev. Rul. 56-24, 1956 -1 C.B. 851). Under this method the following days are included in the calculation :

- part of day;
- day of arrival,
- day of departure,
- all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity,
- short breaks (training, strikes, lock-out, delays in supplies),
- days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the family.

The following days are, however, excluded :

- days spent in the State of activity in transit in the course of trip between two points outside the State of activity

- any entire day spent outside the State, whether for holidays, business trips, or any other reason.

The application of the above method is straightforward as the individual is either present in a country or not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities (*see* paragraph 5 of the OECD Commentary on Article 15)

Remuneration paid by employee who is resident of the State of employment

21.4-2 The second condition relates to the payment by the employer of remuneration for the period of exercise of the employment. He must not be the resident of the State of employment. The object and purpose of this as also of the condition in sub-paragraph (c). The object are to avoid source taxation of short-term employment to the extent that the employment income is not allowed as deductible expense in the State of source because the employer is not taxable in that State as he is neither a resident nor has a permanent establishment therein (*see* paragraph 6.2 of the OECD Commentary). These are to ensure that a Contracting State will not be required to allow a deduction to the payer for the compensation paid and at the same time to exempt the employee on the amount received. Thus, if a non-resident pays a salary of an employee who is employed in the host State, but the host State corporation or permanent establishment reimburses the payer with a payment that can be identified as reimbursement, neither condition (b) nor (c), as the case may be, will be considered to have been satisfied. (*See* Technical Explanation, paragraph 215).

In a fiscally transparent partnership, the concepts "employer" and "resident" are applied at the level of the partners rather than at the level of partnership (*see* OECD Commentary, article 15, paragraph 6.2).

Remuneration - "borne" by permanent establishment

21.4-3 Reference to remuneration "borne by" a permanent establishment or a fixed place encompasses all expenses that are incurred and not merely which are deductible for tax purposes. Paragraph 7 of the OECD Commentary on Article 15 interpreted the expression "borne by" as follows :

"The phrase "borne by" must be interpreted in the light of the underlying purpose of sub-paragraph (c) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that is deductible, having regard to the principles of Article 7, in computing the profits of a permanent establishment situated in the State in which the employment is exercised. In this regard, it must be noted that the fact that the employer has, or has not, actually deducted the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether the remuneration would be allowed deduction for tax purposes; that test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he is entitled."

Thus, remuneration paid by residents that are exempt from taxation may be considered to be borne by a permanent establishment or the fixed base notwithstanding the fact that the expenses are deductible or not, if the payer is exempt from tax.

Exception rule - Abuse of - International hiring out of labour

21.4-4 Paragraph 8 of the OECD Commentary on Article 15 has pointed out how paragraph 2 of that Article could be abused through adoption of the practice known as "hiring out of labour". In this system, a local employer wishing to employ foreign labour for one or more periods of less than 183 days recruits through an intermediary established abroad who purports to be the employer and hires the labour out to the employer. The worker thus fulfils *prima facie* the three conditions laid down by paragraph 2 and may claim exemption from taxation in the country where he is temporary working. "To prevent such abuse, in situations of this type", the Commentary states, "the term 'employer' should be interpreted in the context of paragraph 2. In this respect, it should be noted that the term 'employer' is not defined in the Convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. In cases of international hiring-out of labour, these fictions are to a large extent exercised by the user. In this context substance should prevail over form, *i.e.*, each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user. It is therefore upto the Contracting States to agree on the situations in which the intermediary does not fulfil the conditions required for him to be considered as the employer within the meaning of paragraph 2. In settling this question, the competent may refer not only the above-mentioned indications but to a number of circumstances enabling them to establish the real employer is the user of the labour (and not the foreign intermediary) :

- the hirer does not bear the responsibility or risk for the results produced by the employee's work;
- the authority to instruct the worker lies with the user;
- the work is performed at a place which is under the control and responsibility of the user;
- the remuneration to the hirer is calculated on the basis of time utilised, or there is in other ways a connection between this remuneration and wages received by the employer;
- tools and materials are essentially put at the employee's disposal by the user;
- the number and qualifications of the employees are not solely determined by the hirer."

The basic position, that income is taxable primarily in the state in which the employment is exercised, is subject to exception as contained in paragraph 2. It is not so taxable but taxable in the residence state if

- the recipient is present in that State for a period or periods not exceeding in the aggregate 183 days in a fiscal year concerned; and
- the remuneration is paid by, or on behalf of an employer who is not a resident of that State; and
- the remuneration is not borne by a permanent establishment or a fixed base which the employer has in that state.

The residence state will have the right to tax irrespective of the exercise of employment being in the other state if the circumstances on which the exception operates are shown to exist.

Salary - 183-day rule and 90-day rule

21.5 Notwithstanding any double taxation agreement, the Indian Income-tax Act, 1961 provides exemption [section 10(6)(vi)] in respect of salary income of an employee of a foreign enterprise if

- The foreign enterprise is not engaged in any trade or business in India;
- His stay in India does not exceed in aggregate period of ninety days in the relevant previous year;
- Such remuneration is not liable to be deducted from the income of the employer or chargeable under the Act.

The above rule is popularly known as "90-day rule". Thus, there are two types of exemption : one in respect of residents of the states with which India does not have tax treaty (90-day rule), and the other with which it has (183-day rule). The former exemption is an illustration of unilateral relief. paragraph 2 is an illustration of negotiated exemption.

The qualificatory conditions for exemption under the 90-day rule or the 183-day rule refer to the employer carrying on business in India and the recipient presence in the country. So long as the stay of the recipient does not exceed the prescribed limit, the income will enjoy exemption in India, provided the other conditions as set out are also satisfied. Employment for these rules would mean employment generally and not that it would be confined to one employment under one employer - CIT v. J. Gestin [1986] [161 ITR 563](#) (Cal.)

The "90-days rule" "or the 183-days rule" does not apply, i.e., income becomes taxable, if the employer who pays the remuneration is resident of the State or has a PE in that State which bears it.

Remuneration in respect of employment aboard a ship or aircraft

21.6 Paragraph 3 is an exception to the rules contained in paragraphs 1 and 2, and deals with remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic or aboard a boat engaged in inland waterways transport. Such remuneration is taxed in the State in which the place of effective management of the enterprise is situated. This paragraph follows the pattern as set out in article 8 of taxing income arising from the operation of ships or aircraft, as also of any activity or asset relating thereto in the State of effective management. The remuneration of a crew is not exception.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - DIRECTOR'S FEES

ARTICLE 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.

2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Introduction

22.1 Article 16 deals with fees and other similar payments derived by a person in his capacity as a member of the board of directors of a company and also payments to persons in top managerial positions. Such payments may be taxed in the state of which the company is resident. Paragraph 1 deals with the director and paragraph 2, with top managerial officials.

Director fee - State of company's residence right to tax

22.2 Paragraph 1 provides that fee to individuals who are resident in one state and who are on the board of directors of a company resident in the other state may be taxed in that other state. Other similar payments (such as use of residence or automobile, health or life insurance coverage and club memberships) are similarly taxed. The director's office is located in the place where the control and management of the company is exercised - *McMillan v. Guest* 24 TC 190.

Director - Meaning

22.2-1 Directors are the persons elected by the shareholders and charged under the Companies Act with the responsibility of supervising the affairs of the company. The main functions of the board is policy-making. Their office is permanent and substantive position which is filled by successive office holders and exist independently of the person who fills the office for the time being. The concept determines the location of the director's fee, the place where the company is resident. A company is said to be resident of a place where the central management and control actual abides - *De Beers Consolidated Mines Ltd. v. Howe (Surveyor of Taxes)* [1906] AC 455 (HL). According to article 4, a person is said to be resident of a contracting state if he is liable to tax therein by reason of domicile, residence, place of management or any other criterion of a similar nature. In the case of company the place of management determines residence. The test is where the control and management of the company abides. The control of the company does not mean control by means of the voting power, but the control in relation to company's business. The shareholders can, no doubt, by virtue of their votes control the company. They can compel the directors to do their will. It does not, however, follow that the corporators are managing the corporation. It is the directors elected by them who are managing the affairs of the corporation - *American Thread Co. v. Joyce (Surveyor of Taxes)* [1913] 6 TC 163 (CA). The real business is carried where the directors exercise their control over the company's affairs - *Egyptian Delta Land & Investment Co. Ltd. v. Todd (Inspector of Taxes)* [1929] AC 1. A company is managed by the board of directors. If the meetings of the board of directors are held within India, it can be said that the management is situated in India. The direction, management and control, "the head and seat and directing power" is situated at the place where the directors' meetings are held. Fees and other similar payments in relation to such meetings are, therefore, taxable in the state where the company is resident. Fee is a payment made to the director for his services as a member of the board. Its amount is commonly determined by the company law of the worth of his service to the company. Other payments are not covered under paragraph 1, which may be made for services rendered in a capacity other than as director. Tax treaty with Belgium provides that director's fee and other remuneration will not cover remuneration for the discharge of day-to-day functions of a managerial or technical nature. Treaty with Singapore provides that such remuneration may be taxed in accordance with the provisions of article 14 of that treaty (dependent personal services). The director, therefore, has dual capacity.

Director - Dual capacity

22.3 A director may have a dual capacity; such as a managing director may both be a director as well as an employee. In the capacity of a managing director he may be regarded as having not only the capacity as persona of a director but also has the persona of an employee, or an agent depending upon the nature of his work and the term of his employment. Whether or not a managing director is servant of the company apart from being a director cannot be determined by the articles of association and terms of his employment. As a managing director he functions also as a member of the board of directors whose collective decision he has to carry out in terms of the article of association and he could do nothing which he is not permitted to do. Under the Companies Act the business of the company is managed by the directors - *Ram Prashad v. CIT* [1972] [86 ITR 122](#) (SC). Thus a member of the board of directors having other functions with the company, e.g., as adviser, consultant etc. is not covered by Article 16, insofar as remuneration paid on account of such other functions. In *Von der Mark v. CIT* [1999] [235 ITR 698](#) (AAR), the Authority for Advance Ruling held that "sitting fees" paid to an expert consultant engineer who was appointed as director of an Indian company are taxable under Article 16, and that fees paid for consultancy under Article 14.

Top managerial official remuneration - State of company's residence right

22.4 Paragraph 2 covers salaries, wages and other similar remuneration derived by a resident of a contracting state in his capacity as an official in a top level managerial position of a company. Such payments are taxed in the state of which the company is resident. The "top managerial position" comprises a limited group of officials who have a primary responsibility for the overall direction of the affairs of the company, i.e., the management of the whole or substantially the whole affairs of the company, and may include a director, secretary, manager. Such persons may be those who by the memorandum and articles of association or as a result of action taken by the directors, or by the company in general meeting pursuant to the article, are entrusted with the exercise of the powers of the company. Their salaries, wages and other similar remuneration are taxed in the state of the residence of the company, and not in the state of which these persons are residents or where the employment is exercised, as provided in article 15. The operation of that article is made subject to article 16. The expression "salaries", "wages" and "other similar remuneration" have been discussed in the preceding chapter.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - ARTISTES AND SPORTSPERSONS

ARTICLE 17

ARTISTES AND SPORTSPERSONS

- 1. Notwithstanding the provisions of articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as sportsperson (personally athlete), from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.*
- 2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or a sportsperson himself but to another person, that income may, notwithstanding the provisions of articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or a sportsperson are exercised.*

Introduction

23.1 Article 17 deals with taxation of an individual who derives his income from the exercise of his personal activities abroad as an entertainer or as a sportsperson. Paragraph 1 provides that the income is taxed in the state where such activities are exercised. Article 14 (independent personal service) and article 15 (dependent personal service) do not govern taxation of such income. Thus, tax may be imposed under paragraph 1 even if performer would have been exempt from tax under Article 14 or 15. On the other hand, if the performer would be exempt from the host country under Article 17, but taxable under Article 14 or 15, tax may be imposed thereunder.

Paragraph 2 ensures that such income is taxable in the said State even where it does not accrue to the entertainer or the sportsperson but accrues to a person other than him, as for example, to a company of which he is an employee. The article applies to the self-employed and employed artistes (*see* Hog Road BNB 1984/33 discussed in (1984) ET 342).

Entertainer or sportsperson - Income derived from personal activities

23.1-1 Paragraph 1 applies to income derived by an individual entertainer or a sportsperson by his personal activities as such exercised, *e.g.*, by performing or appearing. If the source is the act of performing or appearing, the income can be said to have been derived, no matter it is not paid directly to the entertainer or sportsperson or to his agent. Income derived as an entertainer or a sportsperson is the subject matter of paragraph 1 of the article. The activities should be of the nature of entertaining the public. For example, the following income is covered—

- Income derived from performance on the stage by an actor or a musician;
 - Income received from activities which involve a political, social, religious or charitable nature, if an entertainment character is present (OECD Commentary, article 17, paragraph 3);
- Income from the activity of a sportsperson;
 - Income from activities such as those deriving from billiards and snooker, chess and bridge tournament (OECD Commentary, paragraph 6).

Article 17 is limited to entertainers or sportsperson performing in the public. The performance may be direct on the stage or indirect through the media. Direct or indirect, it must be for public consumption and entertainment.

Paragraph 8 of the OECD Commentary on Article 17, gives the following illustration of indirect payments :

- In a case where a member of an orchestra company may be paid a salary rather than receive payment for each separate performance, the Contracting State where a performance takes place is entitled to tax the proportion of the musician's salary which corresponds to such a performance;
- where an artiste or sportsman is employed by, *e.g.*, one person company, the State where the performance takes place may tax an appropriate proportion of any remuneration paid to the individual;
- where the domestic laws "look through" entities and treat the income as accruing directly to the individual, paragraph 1 enables that State to tax income derived from appearances in its territory and accruing to the entity for the individual's benefit, even if income is not actually paid as remuneration to the individual.

Entertainer or sportsperson - Income connected with performance such as advertising or sponsorship income

23.1-2 "Personal activities as such exercised" is the criterion for the application of Article 17. It applies to all income connected with the performance, such as appearance fees, award or prize money, and a share of the gate receipts. It also applies to advertising or sponsorship income etc., which is related to directly or indirectly to performances or appearances in a given State. If, however, there is no direct link between the income and a public exhibition by the performer in the country concerned, such income is not covered by paragraph 1. Other Articles become applicable. Income earned as royalties from record sales and payments for product endorsements is not covered. It is covered under Article 12 or Article 14, as the case may be. The Technical Explanation (paragraph 229) explains "For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be exempt from source country under Article 12, even if the performance was conducted in the source country, although he could be taxed in the source country with respect to income from the performance itself under this Article (Article 17) if the dollar threshold is exceeded."

The question whether income falls under Article 17 or other Article, the determining factor would be whether it is attributable to the performance itself or other activities or property rights. It was explained and illustrated by the Technical Explanation on the US Model Convention with the help of the following illustrations, that the fee is so closely associated with performance itself that it would normally fall within Article 17 :

- paid for endorsement of a performance in which the performer will participate;
- a sponsorship fee paid by a business in return for the right to attach its name to the performance.

Payment received for cancellation of a performance however would not fall within that Article. It is neither the fee for performance, nor for appearance or closely associated with either.

Entertainer or sportsperson - Activity covered is only of performing nature

23.1-3 Where an individual fulfils a dual role as a performer and non-performer, such as player - coach or an actor - director, the predominant role will determine the nature of the fee. If his activities are predominantly of a performing nature, Article 17 will apply to all the resulting income he derives in that State. If negligible, the whole income will fall outside it. If it is neither predominant nor negligible, an apportionment is to be made (*see* paragraph 4 of OECD Commentary on Article 17).

Entertainers and sportsperson - Income taxed where activities are exercised

23.2 The State where the activities of an entertainer or a sportsperson are exercised has the right to tax income derived from such exercise. His residence, his stay or the period of stay are all irrelevant consideration for investing the jurisdiction with the source state. The possibility of the residence state taxing it is not altogether ruled out. Exclusion of its jurisdiction would have been inferred if the expression used had been income "shall be taxed" and not "may be taxed".

Entertainer - Meaning of

23.2-1 The article refers to income derived by a resident of a Contracting State—

- as an entertainer, and
- as a sportsperson.

The terms "entertainer" and "sportsperson" have not been defined.

Entertainer in common parlance means a performer or an artiste who entertains professionally on stage. Paragraph 1 of article 17 defines it illustratively. It includes stage performer who is a theatre, motion picture, radio or television artiste or a musician. The list is not exhaustive, but illustrative. It includes all kind of performers who are paid for giving some kind of public performance for the entertainment of public. Performers must be an artiste but all artistes may not be performers such as a painter, sculptor, composer, photographers, cameramen, producers, directors, choreographers, technical staff, road crew for a pop group etc., and cannot be termed entertainer for the purposes of article 17. Similarly, all those who arrange appearance of artistes are not entertainers, such as the managers, agents, or impresarios. Thus, the term "entertainer" includes all those performers who display their skill for remuneration to entertain public.

The expression "entertainer" has been illustratively defined. It includes an artist (theatre, motion picture, radio or television), musician, or an athlete (now substituted by sportsperson). The list is not exhaustive, but illustrative. It includes all kind of performers who are paid for giving some kind of public performance for the entertainment of the paying audience. To make the position more clear, the OECD and UN Model substituted the word "athlete" in both the heading and the text with "sportsman". The expression "athlete" could have been read in a restrictive sense as meaning participants in traditional athletic events such as running, jumping and swimming. Its substitution with the wider expression "sportsman" would include not only such participants but also other entertainers such as footballer, tennis or cricket player. It could therefore, mean that the expression "entertainer" includes all those performers who display their skill or character for remuneration to entertain public as the illustrative examples in the article suggest.

Sportsperson - Meaning

23.2-2 The term 'sportsperson' has not been defined. He also has to be a performer in the playground, like an entertainer on a stage. His function is also to entertain the public. The term is not restricted to participants in traditional athletic events like runners, jumpers, swimmers, but also other entertainers like golfers, jockeys, footballers, cricketer, tennis players, racing drivers etc. (*see* OECD Commentary, article 17, paragraph 5).

Entertainer - Income accruing to another person

23.3 Paragraph 2 is deeming provision which deems income accruing to other person in respect of performance as the income of the performer, and is taxable as such by the source State, notwithstanding that other person has a permanent establishment or a fixed base in the State of performance. That paragraph says that income "in respect of" personal activities exercised by an entertainer in his capacity as such accrues not to himself but to another person, be taxed in the State in which the activities were exercised. The words "in respect of" mean concerning, with regard to or relating to. The source being the performance, and the income having been arisen from such performance, it is to be taxed in the State in which the performance takes place. What is to be taxed is the income from the activity of performance, irrespective of who receives it or to whom accrues whether to the performer himself or to any other person.

Such situation arises if the performer participates directly or indirectly in the profits of the company. If there is no such participation, and the performer is simply an employee on a monthly salary, then Article 17 would not be applicable. That Article deals with the income in respect of personal activities by an entertainer or sportsperson in his capacity as such. Paragraph 1 deals with the first and paragraph 2 with the second situation. The OECD Commentary on Article 17 contemplates three situations :

- (a) management company may receive the income for the performance of e.g., a group of sportspersons (which itself is not constituted as a legal entity);
- (b) a team, troupe, orchestra etc. which is constituted as a legal entity, receives the income;
- (c) a so-called artist company receives the income.

Situation (a) is covered under Article 17. Other situations are discussed in the following paragraphs:

Entertainer or sportsperson - Team, troupe or orchestra

23.3-1 A group of actors or performers or of musicians playing various instruments together may perform and income accrues to that group (a legal entity) in respect of individual performers constituting it. Individual members is liable to tax under paragraph 1 of the Article in the State in which the performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance; however, if the members are paid a fixed remuneration and it would be difficult to allocate a portion of that income to particular performance, the Contracting State may not tax it. The profit element accruing from a performance to the group, a legal entity, would be liable to tax under paragraph 2 of Article 2 [see paragraph 11(b) of the OECD Commentary on Article 17]. That legal entity, even if it has no permanent establishment or fixed base in the country of performance is liable to tax in that country under paragraph 2. Taxation under paragraph 2 is on the person providing services of the performer. This paragraph does not affect the rules of paragraph 1, which apply to the performer himself. The income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

Entertainer or sportsperson - Star company

23.3-2 Paragraph 2 of Article 17 also deals with the potential abuse when the performer's income does not accrue directly to the performer himself, but to another person. The abusive device adopted for this purpose is known as "star or artiste company." A company may be established and owned by the performer of which he is an "employee" on a meagre salary. That company acts as a nominal income recipient in respect of the remuneration for the performance. In the absence of paragraph 2, the income would escape tax in the State of performance because the company earns profits but has no permanent establishment. The performer pays very little tax because remuneration being very meagre. Paragraph 2 prevents this kind of abuse. Under its provision, when an income accrues to a person other than the performer, the income may be taxed in the Contracting State where the performer's service is exercised. Income from the performance accrues to the performer through the agency of the company of which he is the owner. Paragraph 11(c) of the OECD Commentary on Article 17 provides :

"The third situation involves certain tax avoidance in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g., a so-called artiste company. In such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits to impose a tax on profits diverted from the income of the artiste or sportsman to the enterprise. . . ."

Entertainment - Cultural programmes sponsored by public funds

23.4 Some of the Indian agreements provide for exemption to the income if it is derived from any activity or performance pursuant to a cultural programme sponsored by an overseas or the Indian Government, or pursuant to the programme of an overseas non-profit foundation, trust or any other organisation. For example, India/Malaysia tax treaty provides that income shall not be taxed in the contracting state if the visit of the public entertainers or athletes to that state is directly or indirectly supported, wholly or substantially from the public funds of the Government of the other contacting state. For that purpose the term "Government" includes a State Government, a political sub-division, or a local or statutory authority of either contracting state. The agreement with Kenya provides that income would not be taxable which is derived from the activities of the public entertainers and

athletes if their visit to the contracting state is supported wholly or substantially from the public funds of the other contracting states. Similar provision is found in agreements with Sri Lanka, Finland, Singapore, Syrian Arab Republic, Tanzania, Zambia.

Entertainers and athletes - India's approach

23.5 India's approach to article 17 is to follow the UN Model. Its tax treaties normally provide that the source state will not tax income if the visit of the public entertainer is supported by the public funds of the residence state.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - PENSIONS AND SOCIAL SECURITY PAYMENTS

ARTICLE 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

ARTICLE 18A (ALTERNATIVE A)

- 1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.*
- 2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political sub-division or a local authority thereof shall be taxable only in that State.*

ARTICLE 18B (ALTERNATIVE B)

- 1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.*
- 2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.*
- 3. Notwithstanding the provisions of paragraphs 1 and 2, pension paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political sub-division or a local authority thereof shall be taxable in that State.*

Introduction

24.1 Article 18 deals with taxation of pension which a person resident in one contracting state derives on account of his having served in another contracting state. The basic position under the OECD model is that it is taxable in the state of the recipient. The exception is the Government service. In that case it is taxable in the country of the paying Government (article 19). The exclusive right of the residence state was objected to by the developing countries as in their view pension is essentially in the nature of the deferred compensation for the services performed in the source state. Though the right of the residence state is conceded, the source state is also given a right if the payer is the permanent establishment situated in, or is the resident of, that state. If pension and payments are made under a public scheme as a part of social security system of the source state, income is taxable in that state alone and the residence state has no right. Thus, the taxability is judged with reference to (i) the residential status of the recipient, (paragraph 1 of articles 18A and 18B); or (ii) the residential status of the payer (paragraph 2 of article 18B); or (iii) the source of payment, viz., public scheme (paragraph 2 of article 18A and paragraph 3 of article 18B). Provisions as in (i) and (iii) are dealt within article 18A and those in (i), (ii), (iii) in the alternative article 18B of the UN Model.

The types of payment that are covered under article 18 are—

- pensions directly paid to former employees;

- pensions paid to other beneficiaries, e.g., surviving spouses, companions, or children of the employees;
- annuities paid in respect to past employment;

The article applies to payments which are in consideration of past employment and not to any other pensions such as those paid with respect to previous independent personal services (*see* OECD Commentary, article 18, paragraph 7).

Pensions - Residence State right to tax

24.2 Paragraph 1 lays down a basic proposition that pensions and other similar remuneration paid by contracting state in consideration of past services of a person now resident of another state is taxable in the residence state. The special rule for taxing pensions in respect of Government services in the country of the paying Government as contained in article 19 overrides the general rule.

Pensions - Meaning

24.3 The expressions "pensions" and "other similar remuneration" have been generally defined to represent consideration of past employment. Pension is a periodical payment of money for past services—*Shaukat Husain Beg Mirza v. State of UP* AIR 1959 All. 769 and *Raj Kumar Bikram Bahadur Singh v. CIT* AIR 1969 MP 127. It is closely akin to wages in that it consists of payment provided by an employer, and paid in consideration of past service. It serves the purpose of helping the recipient meet the expenses of living—*Dodge v. Board of Education* [1937] 302 US 74. It is neither a bounty nor a matter of grace depending upon the sweet will of the employer. It creates a vested right in the pensioner for payment for past services rendered. The said right vests in the pensioner because of the past employment. The said past employment is in continuation of the relationship of employer and employee, which existed prior to the retirement of the pensioner—*Deokinandan Prasad v. State of Bihar* AIR 1971 SC 1409 and *State of Punjab v. Iqbal Singh* AIR 1976 SC 667. It is paid to an employee following his retirement from service due to age or disability, or to the surviving dependents of an employee entitled to such pension in consideration of past services. Thus, the right to pension of an employee on his retirement, or of his widow or of orphan child on his death, flows from the past employment. It flows as part of the consideration of the contract of employment and not *de hors*, or independent of, the contract or employment. The benefit of pension is in the nature of deferred wages - *CIT v. Smt. Dipali Goswami* [1985] [156 ITR 36](#) (Cal.). It is, therefore, closely akin to wages. The characteristics of pension as understood now-a-days can be summed up as follows - *D.S. Nakara v. Union of India* AIR 1983 SC 130.

- ◆ The pension is neither a bounty nor a matter of grace depending upon the sweet will of the employer
- ◆ The pension is not an *ex gratia* payment but it is a payment for the past services rendered
- ◆ It is a social welfare measure rendering socio-economic justice to those who in the key day of their life ceaselessly toiled for the employer on an assurance that in their old age they would not be left in the lurch.

Pension, therefore, means a pension, whether contributor, or not, of any kind whatsoever payable to or in respect of any person and includes a retired pay so payable, a gratuity so payable, and any sum or sums so payable by way of the return, with or without interest therein or any other addition thereto, or subscription to a provident fund—*Constitution of India Article 336(7)*.

Pensions - Defined in tax treaties

24.3-1 OECD Commentary defines the term "pension" as periodic payments that are made in consideration of past employment. Non-periodic payments are also covered within the expression "other similar remuneration".

The definition of the word "pension" in a tax treaty is no way different from the concept as discussed in the preceding paragraph. It is generally understood to mean payment made in consideration of past services. It also sometimes is taken to mean compensation for injury (*see*, for example, agreement with Austria, Brazil, Czech Republic, Norway, Sri Lanka, Tanzania, Thailand, Zambia). The injury should be sustained in the course of performance of services. The word "injury" denotes any harm whatever illegally caused to any person in body, mind, reputation or property. It is a wrongful action or treatment harm or damage. It has relation only to acts which are wrongful—*Anisetti Venkanna v. Rimalapudi Venkata Rao* AIR 1957 AP 453. Whenever there is an invasion of a legal right, the affected person is entitled to bring an action. He may be awarded damages although he might have suffered no actual damage. Every injury imports a damage when a man thereby hindered of his right. The damage is not merely pecuniary. Compensation of the injury suffered by a person is defined in some tax treaties to mean pension.

Pension - Other similar remuneration

24.4 The word "remuneration" includes "recompense", "reward" or "payment"— *CIT v. Calcutta Stock Exchange Association Ltd.* [1959] [36 ITR 222](#) (SC). It has been qualified with the words "other similar". The remuneration, therefore, refers to payment which partakes the character of pension or injury.

The expression "other remuneration" is broad enough to cover even non-periodic payment; for example, lump sum payment in lieu of periodic pension payments, commutation of, or compensation for a reduced, pension (OECD Commentary, article 18, paragraphs 5 and 6). Whether a particular payment following cessation of employment is considered "other similar remuneration" for the purposes of article 18 or as a final remuneration for work is determined by its nature, having regard to the facts and circumstances in which it is made. Important factors to be considered are—

- the source of payment; for example, payments made from a pension scheme but not reimbursement of pension contribution;
- whether a payment is made on or after cessation of the employment;
- whether the recipient continues working;
- whether the recipient has reached the normal age of retirement;
- the status of other recipients who qualify for the same type of payment and
- whether the recipient is simultaneously eligible for other pension benefits

(see OECD Commentary, paragraph 6).

Payment in consideration of past employment, whether periodic, non-periodic or lump sum is covered by the article. Payment for any other consideration falls outside its scope. For example, annuity acquired directly by the annuitant from the capital that has not been funded from the employment pension scheme (OECD Commentary, paragraph 3).

Some treaties have defined the term "pension" as including annuity and even alimony.

Pensions - Annuity

24.4-1 The expression "annuity" has been defined in an agreement with Belgium to mean a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate or full consideration in money or money's worth. The expression generally means sums payable in respect of a particular year; yearly grant. It is a certain sum of money payable yearly either as a personal obligation of the grantor or out of property. The hall mark of annuity according to Jarman on Wills is (1) it is money, (2) paid annually, (3) in fixed sum, and (4) usually it is a charge personally on the grantor. The expression "annuity" has assumed a legal term owing to judicial interpretation and not its popular and dictionary meaning - *Ahmed G.H. Ariff v. CWT* [1970] [76 ITR 471](#) (SC). In order to constitute an "annuity", the payment is made annually to be fixed or predetermined one and it should not be liable to variation depending upon or on any ground relating to the general income of fund or the estate which was charged for such payment - *CWT v. P. K. Banerjee* [1980] [125 ITR 641](#) (SC). A fixed amount paid annually out of property in lieu of previous obligation is an annuity - *Nawab Sir Mir Osman Ali Khan v. CWT* [1986] [162 ITR 888](#) (SC).

In ordinary sense it means the purchase of income. But in all circumstances it is not so. The annual payments are sometimes loosely called annuity when they are in fact annual instalments of capital. The nature of annuity is finally determined by the circumstances that the obligation is to pay a capital sum and instalments are merely a method of effecting payments - *Eklingji Trust v. CIT* [1986] [158 ITR 810](#) (Raj.).

Pensions - Alimony

24.4-2 Alimony is the means of living, maintenance, an allowance made to a woman for her support by a man pending or after her legal separation or divorce from him; the allowance ordered by the Court to be made to a wife from her husband; estate for her support in a pending matrimonial suit. On any petition for divorce or nullity of marriage, or for judicial separation or restitution of conjugal rights, the court may make such interim orders for the payment of alimony to the wife as the court thinks just. It takes the form of money payment payable weekly or monthly.

The agreement with Norway provides that alimony received by a resident of Norway and paid by a resident of India is not taxable in Norway, to the extent such payments are not deductible for the purpose of Indian tax.

Pensions - Gratuity or provident fund or gifts

24.4-3 If the payment originates from the facts of a person having rendered services in the past, it is generally taxable as per provision of article 18. But every remuneration may not partake the character of pension or payment similar to it, according to domestic laws of the Contracting State. The characteristic of pension is the receipt of money from the former employer on account of past employment. But such payment is deemed 'salary' under the Indian Income-tax Act. Pension or annuity has also been encompassed within the ambit of 'salary' besides wages, gratuity, etc. Since pensions or annuity are dealt with separately, whether other payments which are given on retirement or superannuation on account of past employment could be taken remuneration as resembling pension or when payment is made in appreciation of past employment whether it could be taken income or gift.

Amounts paid to employees on cessation of their employment as terminal benefits are taken to be salary under Indian Income-tax Act. The retrial benefits like gratuity, provident fund and pension (known as triple benefits) are given as social security measures to protect the employee against loss of income due to unemployment arising out of incapacity to work because of invalidity, infirmity or old age. Though such payments (excepting pension) should normally fall within the expression 'other similar remuneration', these are taken to be salary, and are taxable as such if otherwise so taxable under the Indian tax laws. In such a case, it would be natural to consider the income as falling under article 15, or under article 19, as the case may be. The conflict could be resolved by mutual agreement, under article 25.

If the consideration is the past employment, the payment could be taken either salary or a gift, depending upon in what character the person has received the amount. If the voluntary payment is made in the circumstances which shows that it is given by way of present or a testimonial on grounds of personal to the recipient in appreciation of the personal qualities of the concerned person and as a token of personal esteem for him it would amount to a gift; but if the payment is made substantially in token of an appreciation of the services rendered by him to the donor or as a reward for services or assistance rendered by him then it cannot be considered to be a mere gift—*CIT v. Keshri Singh* [1977] [106 ITR 184](#) (Raj.) and *Mahesh Anantrai Pattani v. CIT* [1961] [41 ITR 481](#) (SC). It has, therefore, to be decided whether it is a personal gift or it is remuneration. If it is the latter, it will be subject to tax but if it is the former it will not be taxed.

Pension - Payments under social scheme

24.5 Paragraph 2 of article 18A and paragraph 3 of article 18B deal with pensions paid and other payments made under public scheme - which is a part of the social security system. Such amount is to be taxed in the State of which such a social security system is part, notwithstanding the provision of the preceding paragraph(s) that is the residence State to levy tax. The Government of India have taken many social security and welfare schemes and enacted Acts to implement them, viz., Workmen's Compensation Act, 1923; Maternity Benefit Act, 1961; Employees' State Insurance Act, 1948; Employees' Provident Funds and Miscellaneous Provisions Act, 1952; Payment of Gratuity Act, 1972; and many others.

Some of these Acts entitle a person or members of his family to receive payment for 'undeserved want' such as sickness, maternity, employment, injury, old age, unemployment, disability or even death. While some other are sources for financing the welfare schemes such as relief to the poor, education, medical relief and promoting justice. These Acts and the schemes made thereunder seek to reduce the threat to the economic security of the individual, by attempting to reduce an individual's or a family's loss of income and welfare. This is done by providing cash benefits, compensation for the loss of income medical and other assistance. Categories of economic insecurity are mainly three :

- ◆ Risk of physical inability to work resulting in loss of earning capacity and power and consequently income : for example, sickness, maternity, accidents, old age and death
- ◆ Economic risk, primarily that of involuntary unemployment
- ◆ Economic burden of large family.

All social security schemes originate from the concept of distribution of justice which connotes, *inter alia*, removal of economic inequalities, and rectifying the injustice resulting from dealings or transactions between unequals in society. Distribution of justice means a fair division of wealth among the members of society based on the principle "from each according to his capacity, to each according to his needs" and it comprehends transfer of resources to

increase total national welfare. If a social welfare programme is financed by a progressive taxation, the transfer is from the rich to the poor. If it is financed primarily by payments to workers and employees, the resources are transferred within the same class of persons, from the more fortunate to the less fortunate. All schemes which are used as instruments of distribution of justice may take the form of forced distribution of wealth as means of achieving a fair division of material resources among the members of society—*Lingappa Pochannappa v. State of Maharashtra* AIR 1985 SC 389. The actual benefits may be distributed through old age survivors and disability payments, unemployment compensation, family allowances. Payments and allowances made under such public scheme of a Contracting State are taxable only in that State, and not in the residence State.

Pension under social scheme - Residence State no authority if not taxed by the Source State

24.5-1 The residence State does not tax pensions or other payments made under a public scheme. Only the source State has the right. Even if it does not tax, the residence State cannot tax. In *Estate of Michael Hausmann v. Her Majesty the Queen* 1998 Can. Tax Ct. LEXIS 1140, question was whether the pension received by Mr. Hausmann from the pension office of the Belgian Government was taxable in Canada. The facts indicated that there was no tax withheld at source in Belgium. The argument of the Canadian Tax Authorities was that if Belgium was not going to tax the pension, Canada should. Otherwise, the unthinkable might occur and the amount might not be taxed by anyone. This would be anathema. The facts indicated that the payment received by Mr. Hausmann fell below the prescribed threshold and therefore was not taxed in Belgium. The Canadian court rejected the argument that if Belgium did not tax the payment, it must be taxed by the Canada as plainly wrong by relying on the terms of the treaty. On the basis of the material available, the Federal Court came to the inference that in negotiating the Belgium treaty both Canada and Belgium unquestionably regarded pensions paid under their social security legislation, such as the CPP or the corresponding Belgian statutory scheme, to be taxable only in the country from which they emanated and not the country of residence of the recipient. Hence, it was held that the pension payments received by Mr. Hausmann from the office of Belgium were social security pension and such allowances could be taxable only in Belgium. The fact that Belgium did not choose to tax them was held to be totally irrelevant.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - GOVERNMENT SERVICE (REMUNERATION AND PENSION)

ARTICLE 19

GOVERNMENT SERVICE

1. (a) *Salaries, wages and other similar Remuneration, other than a pension, paid by a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.*

(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who :

(i) is a national of that State; or

(ii) did not become a resident of that State solely for the purpose of rendering the services.

2. (a) *Any pension paid by, or out of funds created by a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.*

(b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.

3. *The provisions of articles 15, 16 and 18 shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political sub-division or a local authority thereof.*

IntroductionIntroduction

25.1 Article 19 deals with salaries, wages or similar remuneration and pension in respect of Government service. Paragraph 1 applies to salaries, wages or similar remuneration; paragraph 2, pension. Paragraph 3 is an exception. The article does not apply to salaries, wages or similar remuneration and pension in respect of services rendered in connection with business carried on by the contracting state or a political - sub or a local authority thereof. In that case articles 15, 16 and 18 are applicable. What is thus to be seen is whether services are rendered to state in the discharge of functions of a Governmental nature or rendered to it in connection with business carried on by it. In the former case article 19 is applicable; in the latter, articles 15 (Dependent services), 16 (Director's fee) and 18 (Pensions). Article 19 gives exclusive right to the paying state to levy tax. In relation to employees working inside the other country exclusive right is given to that country if the employee is its national, or did not become resident there solely for the purpose of rendering services of the paying country.

Government Service - Salaries, wages or similar RemunerationGovernment Service - Salaries, wages or similar Remuneration

25.2 The expression "salaries, wages and other similar remuneration" includes benefits in kind received in respect of services rendered to a State or political sub-division or local authority thereof (*e.g.*, the use of a residence or automobile, health or life insurance coverage and club membership) (*see* paragraph 2.2 of the OECD Commentary on Article 19). The exclusivity of the right to tax remuneration paid by the State or its political sub-division or local authority could be inferred from the words 'shall be taxable only in that State' found in paragraph 1(a). The remuneration should be the one which is paid to an individual, and for services rendered to the State or sub-division or the authority. The place of rendering service is not relevant for this article.

The principle of giving the exclusive taxing right has now been internationally accepted, as it accords with the conception of international courtesy and with the provisions of the Vienna Convention, as Diplomatic and Consular relations.

There is reciprocity about exempting income from tax earned by the employee of a foreign State in the host country. The Indian Income-tax Act contains a provision - *see* section 10(6)(xi), for exclusion of income in case of an individual who is not a citizen of India, remuneration received as an employee of the Government of a foreign State during his stay in India in connection with his training in any establishment or office of, or in any undertaking—owned by the Government, or the company owned by the Government, or its subsidiary or corporation established by an Act, or society wholly financed by the Government. Another provision section 10(6)(ii), relates to the remuneration received by an individual who is not a citizen of India as an official, by whatever name called, of any embassy, high commission, legation, commission, consulate or the trade representation of a foreign State, or as a member of the staff of any of these officials, for service in such capacity.

The exemption is granted provided the corresponding officials of the Government of India enjoy similar exemption in the country concerned, and also that such members of the staff are subjects of country represented and are not engaged in any business or profession or employment in India otherwise as member of such staff.

This paragraph does not insist upon the individual being the national or resident of the payer State. The satisfaction of the condition of his rendering service to the payer State is sufficient for the operation of its exclusive right to levy tax.

An exception from the principle of giving exclusive taxing power to the paying State is contained in sub-paragraph (b) of paragraph 1.

If the recipient is an individual resident of the State in which services are rendered, and who has not become resident of that State for purpose of rendering services or is the national of that State, the right to levy tax on such remuneration has been given to that State. That remuneration alone which has been mentioned in (a) of paragraph 1 would fall within the exclusive right of the State by virtue of clause (b). The word 'such' qualifying 'remuneration' connotes remuneration which has been mentioned earlier. In *M.G. Kollankulan v. CIT* [1978] [115 ITR 160](#) (Ker.), the High Court held that the words 'such assets' connote which have been mentioned earlier in the

section, that is, the remuneration other than a pension paid by a Contracting State or its political sub-division or local authority to an individual for services rendered to that State or sub-division or authority.

Government service - PensionGovernment service - Pension

25.3 While paragraph 1 deals with remuneration, paragraph 2 deals with pension paid by the Contracting State or its sub-division or local authority, or out of funds created by it, in respect of services rendered to that State. It is in *pari materia* with paragraph 1. As in respect of remuneration, in respect of pension also the right to levy tax is given to the payer State. But in case the recipient is the resident of and also a national of the other State, the right is given to that State.

Government service - Remuneration and pension should be incidentsGovernment service - Remuneration and pension should be incidents

25.4 Employment under a Government of a person is a matter of status and there is a passive employment link between the pensioner and the Government though that link is an active link of employer-employee prior to his retirement. The past employment is in continuation of the relationship of employer and employee, which existed prior to the retirement of the pensioner. Pension is closely akin to wages in that it consists of payment provided by an employer, is paid in consideration of past services - *Dodge v. Board of Education* [1937] 302 US 74.

There is thus basically no difference between remuneration referred to in paragraph 2B, both are incidents of services rendered to the State or its sub-division or local authority.

Government service - Remuneration for services rendered in connection with businessGovernment service - Remuneration for services rendered in connection with business

25.5 Paragraphs 1 and 2 do not apply if the remunerations and pensions are paid in respect of services rendered in connection with a business carried on by State or its political sub-division or local authorities. If the nature of services is such as to qualify the remuneration as salary and wages, or as fee to a director or as pension as if in respect of private employment, rules contained in the respective articles 15, 16 and 18 apply. However, services rendered by artistes and the athletes even if they relate to the business carried on by the State or its sub-division or local authority would continue to be governed by paragraphs 1 and 2, because reference to article 17 has been made conspicuously absent.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - STUDENTS AND APPRENTICES

ARTICLE 20

STUDENTS

1. *Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.*

2. *In respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting. (Since been deleted)*

IntroductionIntroduction

26.1 Article 20 deals with payments to a student or business apprentice for the purpose of his maintenance, education or training. All such payments received from sources outside the State in which he is staying shall be exempted from tax in that State. Besides, he is also entitled to the same exemptions, reliefs or reductions as are available to the residents of that State in respect of grants, scholarships and remunerations from employment. This article, therefore, encourages free flow of students and business apprentices for acquiring knowledge and skills.

Students and apprentices - Payment exempt

26.2 Paragraph 1 contains the rule regarding exemption of the amount received by a student or business apprentice, from the sources outside the State in which he has been staying, provided that (1) he is or was immediately before coming to the Contracting State for education or training, resident of the other Contracting State; (2) he is present in the Contracting State for the purpose of education or training; (3) he receives the aforesaid amount for the purpose of his maintenance, education or training.

The presence of the word 'immediately' is significant. The benefit under this article is intended to be given to a resident of the Contracting State as on now and not to the person who has been once its resident and presently is the resident of the third State. Residence has reference to the physical connection of a person with a particular territory which connection should not be separated by any intervening period when the person visits the other Contracting State for education or training. The continuity of the physical connection with the territory of the Contracting State should be existing, immediately before he visits the other Contracting State for education or training.

The expression 'student' or 'business apprentice' has been left undefined in the article. Individual agreement, however, has been limiting or extending the scope of the article by giving meaning to these expressions. The word 'student' has been used with reference to a person studying at university, college or school or recognised institution (approved by the competent authority) (*see* agreements with Austria, Belgium, Czechoslovakia, Denmark, Sweden, France, Greece, Italy, Japan, Malaysia, Hungary, Great Britain, Singapore, UAR, Zambia) and the words 'business apprentice' have been extended to include 'technical apprentice' (*see* agreements with Japan, Hungary, Malaysia, New Zealand, Singapore, UAR) and technical, agriculture and forestry (agreement with Finland). Agreement with Japan has defined it to mean an individual having little or no technical or professional experience and the agreements with Great Britain, Zambia with reference to securing training required to qualify him to practise a profession or a professional speciality.

In fact for the qualification of benefit under many agreements, a person need not be a student or business apprentice. It is enough if he is an individual who is recipient of grant, allowance or award for the primary purpose of study or research from a religious, charitable, scientific or educational organisation (agreements with Austria, Denmark, France, Greece, Italy, Japan, Malaysia, Singapore, Sweden, Czechoslovakia, Hungary, UAR, Great Britain, Zambia) or who is recipient of remuneration in respect of training, research or study under the arrangements with the Government of the Contracting State (agreements with Austria, France, Japan, Malaysia, Singapore, Great Britain, Zambia). Remittance from abroad, grant, scholarship or award, or remuneration from employment for the purpose of maintenance, education or training is exempt. The exemption, therefore, relates to :

- a. remuneration and all remittances from abroad for the purposes of maintenance, education and training;
- b. grants, allowances and award;
- c. amounts representing remuneration from an employment in the Contracting State;
- d. remuneration as an employee of or under a contract with an enterprise of a Contracting State or Governmental, religious, charitable or educational organisation for acquiring technical, professional or business, experience from a person such an enterprise or organisation.

For such exemptions, however, the presence of the person has to be temporary and the amount should also be within the agreed limit. There is thus a limit of period and amount. Normally such limits are not meant for student or apprentice in respect of remittance from abroad but are prescribed for an individual who receives remuneration for services rendered for the purpose of study, research and training, or receives it from the Government for that purpose.

As regards period, it is the period of time as may be reasonably or customarily required for the visit; the upper limit is 5 years (*see* agreements with Great Britain, Hungary, Indonesia, Korea, Malaysia, Singapore, Mauritius, Syria, Zambia) or 3 years (*see* agreements with Kenya, Sweden, Tanzania) or one year in case when an individual from one territory visits the other territory temporarily as an employee of or under a contract with an enterprise of the

former territory, or a governmental, religious, charitable, scientific or educational organisation solely to acquire technical, professional or business experience from a person such an enterprise or organisation (*see* agreements with Austria, Belgium, FGR, France, Great Britain, Italy, Japan, Malaysia, Singapore). The monetary limit has also been provided in majority of the agreements.

Students and apprentices - Payments solely for the purpose of education and training

26.3 The payment referred to in article 20 which qualifies for exemption must be received solely for the purpose of education and training. ‘Solely’ means only and exclusively. The proposition ‘for’ connotes the end result, with reference to which something is done - *Addl. CIT v. Surat Art Silk Cloth Mfg. Association* [1980] 121 ITR 1 (SC). It is, therefore, not enough that a student or an apprentice should receive the payment. He should receive it with the purpose of his maintenance, education or training. ‘Purpose’ means design of effecting something, and is different from ‘motive’. ‘Motive’ is a force which impels a person to adopt a particular course of action which is highly subjective in character and be found mainly from a course of conduct. But the purpose is more apparent and has immediate connection with the result which is brought about. What is the result which is brought about by the amount received by a student or business apprentice? If the answer is that the amount which enables the student or apprentice to pursue his education or training it could be said to have been done for the purpose of his maintenance, education or training. The expression ‘for the purpose of maintenance, education or training’ comprehends all acts incidental to the pursuit of education or training. Its range is wide. It covers not only the pursuit of education or training but also maintenance of the student or apprentice to enable him to have the pursuit, for example, food, clothing, shelter, etc. It legitimately comprehends many other incidental acts. It has, however, its own limitations which are implicit on it. The purpose must be for the purpose of education or training, that is to say that the amount is received by him for his maintenance, education or training. The object, plan and design of which must have connection or relationship with education or training. To comprehend the implication of this paragraph it is necessary to explain words ‘education’, ‘training’ and ‘maintenance’. The following paras contain the discussion.

Students and apprentices - ‘Education’ - Meaning of

26.4 Education connotes the process of training and developing the knowledge, skills, mind and character of students by normal schooling - *Sole Trustee, Loka Shikshana Trust v. CIT* [1975] [101 ITR 234](#) (SC). The expression is not so wide and extensive according to which every acquisition of further knowledge constitutes education. The education may be technical, professional or general. Technical education is concerned with teaching, applied sciences, special training in applied sciences, technical procedures and skills required for practice of trade or profession, especially those involving the use of machinery or scientific equipment. Technical education may be distinguished from professional education which places major emphasis upon the theories, understanding and principles of a wide body of subject-matter designed to equip the graduate to practise in such fields as medicine, law and engineering - *J.K. (Bombay) Ltd. v. CBDT* [1979] 118 ITR 312 (Delhi). General education comprises all other learning from pre-school conditioning to advanced studies in the liberal arts and sciences.

Students and apprentices - ‘Training’ - Meaning of

26.5 ‘Training’ means practical education in any profession, art or handicraft to bring a person to a desired state of standard of efficiency.

Students and apprentices - ‘Maintenance’ - Meaning of

26.6 The word ‘maintenance’ means the act of maintaining, supporting, continuance or causing to continue and carrying on or causing to continue education or training as covered under paragraph 1 of the article.

Students and apprentices - Grants scholarship and remuneration - Exemption

26.7 The amount received may be designated as grant or scholarship, or may be given other nomenclature, or may even represent remuneration from employment. So long as its purpose is for maintenance, education or training, the amount would continue qualifying for exemption from taxation provided other conditions as specified in paragraph 1 are satisfied. One such condition is that arising of the income is from the sources outside the

Contracting State. But income arising from sources in the visiting State, it also qualifies for exemption or for rebate in the same manner as in respect of residents of that State.

Paragraph 2 deals with such grant, scholarship or remuneration as is not covered by paragraph 1. In respect of these the student/apprentice becomes eligible for personal exemption and in respect of other allowance allowed to the residents of the visiting State. Remuneration even if it is connected with the pursuit of education and study is not unlimited in terms of amount and period.

Students and apprentices treaties - India's approach

26.8 India follows not only UN Model in its treaties but extends the treaty benefits to some other items not covered by it. Exemption is provided in respect of :

- a. Remittances from abroad;
- b. Grant, allowance, reward or scholarship from a religious, charitable, scientific or educational organisation;
- c. Remuneration from employment if the amount is related with his study for his training or if it is necessary for his maintenance, subject to monetary limit;
- d. Remuneration for his services directly related to acquire technical, professional or business experience, if the resident of the contracting state is present in the other contracting state temporarily for a period not exceeding as an employee of an enterprise of the first contracting state or an organisation referred to in *b* above, subject to a threshold monetary limit;
- e. Remuneration received on account of training, study or orientation if he is present temporarily in the other contracting state under an arrangement with the Government or other contracting State or any agency thereof.

Treaty-wise benefits are summarised in the appendix in the same order as above; *a*, *b*, *c*, *d*, and *e*.

APPENDIX

SHOWING INDIAN TREATIES BENEFITS TO STUDENTS AND APPRENTICES

Country	<i>a</i>	<i>b</i>	<i>c</i>	<i>d</i>	<i>e</i>	Benefits available for
Armenia	Yes	-	Yes	-	-	-
Australia	Yes	-	-	-	-	
Austria	Yes	-	Yes	-	-	5 years
			(not more than 183 days in a year)			
Austria	Yes	Yes	Yes	Yes	Yes	
				(50,000	(80,000	
				Austrian	Austrian	
				Shillings)	Shillings)	
Bangladesh	Yes	Yes	Yes	Yes	Yes	
			(15,000	(12,000		
			p.a.)	p.a.)		

Belarus	Yes	-	Yes	-	-	5 years
Belgium	Yes	Yes	Yes	Yes	-	
			(100,000	(120,000		
			Belgian	Belgian		
			Francs)	Francs)		
Brazil	Yes	Yes	-	-	-	5 years
Bulgaria	Yes	-	Yes	-	-	-do-
			(LEV. 1,500)			
Canada	Yes	-	-	-	-	
China	Yes	Yes	Yes	-	-	
Cyprus	Yes	-	Yes	-	-	3 years
			(US \$ 5,000)			
Czech	Yes	Yes	-	-	-	7 years
Denmark	Yes	-	Yes	-	-	5 years
			(20,000 Danish Crowns)			
Finland	Yes	-	Yes	-	-	183 days
France	Yes	-	-	-	-	
Germany	Yes	Yes	Yes	-	-	
			(DM 7,200)			
Greece	Yes	Yes	Yes	-	-	
Hungary	Yes	-	Yes	-	-	7 years
Indonesia	Yes	-	Yes	-	-	5 years
			(Rs. 20,000 or R.P. 20,00,000)			
Ireland	Yes	-	Yes	-	-	6 years

Israel	Yes	-	Yes	-	-	3 years
			(US \$ 3,000)			
Italy	Yes	Yes	Yes	Yes	-	1 year
			(5,000,000 Italian Liras)			
Japan	Yes	-	-	-	-	
Jordan	Yes	-	Yes	-	-	5 years
			(US \$ 500)			
Kazakhstan	Yes	-	-	Yes (not exceeding which exempt under the domestic law)	-	7 years
Kenya	Yes	-	-	-	-	3 years
Korea	Yes	-	Yes	Million and seven hundred thousand Korean Won		5 years
Kyrgyz Republic	Yes	-	Yes	-	-	5 years
Libya	Yes	-	Yes	-		
Malaysia	Yes	Yes	Yes		Yes	7 years
			(2,000 US dollars)	-		
Malta	Yes	Yes	Yes	-		
			(US \$ 3,000)			
Mongolia	Yes	Yes	Yes	-	-	- 5 years
Mauritius	Yes	-	Yes	-	-	- 5 years

				(Rs. 15,000)				
Namibia	Yes	-	Yes	-	-			3 years
Nepal	Yes	-	Yes	-	-	-		3 years
				(Rs. 18,000)				
Netherlands	Yes	-	Yes	-	-	-		5 years
				(5,000 Guilders)				
New Zealand	Yes	Yes	-	-	-	-		
Norway	Yes	Yes	-	-	-	-		
Oman	Yes	-	Yes					
		-	(US \$ 2,000)					
Philippines	Yes	-	Yes		-	-		3 years
				(Rs. 15,000)				
Poland	Yes	-	Yes		-	-		5 years
Portugal	Yes	-	Yes	-	-	-		2 years
				(US \$ 3000)				
Qatar	Yes	-	Yes	-	-	-		-
				(US \$ 1000)				
Romania	Yes	Yes	Yes	-	-	Yes		6 years
Russia	Yes	-	-	-	-	-		
Singapore	Yes	Yes	Yes		-	-		5 years

				(US \$ 500 per month)				
Slovenia	Yes	-	Yes		-	-	5 years	
				183 days in any period of 12 months				
South Africa	Yes	-	Yes		-	-	5 years	
				(US \$ 3,000)				
Spain	Yes	-	-		-	-		
Sri Lanka	Yes	Yes	-		-	-		
Sudan	Yes	Yes	-	-	-	-	6 years	
Sweden	Yes	-	Yes		-	-	5 years	
				(10,000 Swedish Kronor)				
Switzerland	Yes	Yes	-		-	-		
Syria	Yes	-	Yes		-	-	5 years	
				(Rs. 15,000)				
Tanzania	Yes	-	Yes		-	-	3 years	
				(Rs. 10,000)				
Thailand	Yes	Yes	Yes		-	-		
				(Rs. 15,000)				
Trinidad and Tobago	Yes	-	Yes	-	-	-	7 years	
Turkey	Yes	-	Yes		-	-		

			(for period of 183 days)				
Turkmenistan	Yes	-	Yes		-	-	5 years
			(US \$ 500)				
UAE	Yes	Yes	Yes		Yes	Yes	
			(Rs. 20,000)				
UAR	Yes	Yes	Yes		-	-	
UK	Yes	Yes	Yes		Yes	Yes	5 years
			(750 Pounds)				
Uganda	Yes	-	-	-	-	-	5 years
Ukraine	Yes	-	Yes	-	-		5 years
			(US \$ 500)				
USA	Yes	Yes	-	-	-		
Uzbekistan	Yes	-	Yes		-	-	3 years
			(US \$ 700)				
Vietnam	Yes	-	Yes		-	-	5 years
			(US \$ 2,000)				
Zambia	Yes	Yes	Yes (1,500		Yes		5 years
			Zambian Kwacha)		(3,500 Zambian Kwacha)		

DOUBLE TAXATION AGREEMENT - OTHER INCOME

ARTICLE 21

OTHER INCOME

- 1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention shall be taxable only in that State.*
- 2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is 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.*
- 3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.*

IntroductionIntroduction

27.1 Income not dealt with in any of the preceding articles is dealt with under article 21. Each article specifies nature of income and then defines the income sought to be covered by it. Because of its nature or its source, if an income could not be dealt with under any of them, it is dealt with in article 21. It also covers income arising in the third state. Being residuary, it comes into operation only when the preceding articles are excluded. Paragraph 1 lays down its basic proposition, that all income whose taxation is not discussed and also not dealt with in other articles should be taxed in the state of residence of the beneficiary. It is, however, not applicable to income which is effectively connected with permanent establishment (article 7) or a fixed base (article 14) (paragraph 2). Paragraph 3 provides that income of a resident of a contracting state not dealt with in the preceding articles and arising in the other Contracting State may also be taxed in that other State.

Other income - Residence State right to taxOther income - Residence State right to tax

27.2 Paragraph 1 provides that income which has not been dealt with in any of the other articles of the tax treaty shall be taxable in the state of his residence. Its basic feature is that the state of residence of the recipient of income the taxation of which is not covered by other articles of the tax treaty, has the right to tax it. The right is exclusive. It is irrespective of where such income arises. The expression "taxable" does not suggest that income must be taxed and if it is not taxed, it could be done by the other state. Non-exercise of the right by the state of residence does not mean its forfeiture or non-existence. Once the right is vested, it cannot be taken away on account of its non-exercise. Its exercise is not presumed to be a precondition of its existence. The exclusive right is, however, subject to paragraph 3. The income may also be taxable in the other Contracting State if its source exists in that state. Paragraph 2 also contains an exception with respect to income from carrying of business through permanent establishment or exercise of professional service through fixed place.

Other income - Not dealt with under any articlesOther income - Not dealt with under any articles

27.3 Paragraph 1 not only covers income which is not covered but also income not dealt with in any of the preceding articles of the tax treaty.

An income is "dealt with" in another article if it is the type of income described in the article and it has the source in a Contracting State. For example, all royalty income that arises in a Contracting State and paid to the resident of another State is "dealt with" in article 12 (Royalties). Income not dealt with in the other article is the income of class not expressly dealt with in it. It is also the income from sources not expressly mentioned. The scope of article 21 is not confined to income arising in a Contracting State; it extends also to income from the third State (*see* paragraph 1 of the OECD Commentary on article 21).

Examples of items of income covered by article 21 include (*see* paragraph 274 of the Technical *Explanation* on the US Model Convention)—

- income from gambling, punitive (but not compensatory) damages, covenants not to compete
- income from certain financial instruments to the extent derived by persons not engaged in the trade or business of dealing with such instruments (unless the transaction giving rise to the income is related to a trade or business, in which case it is dealt with under article 7)
- income not dealt with in other articles because of their source or some other characteristic. For example, interest arising in a third State that is not attributable to the permanent establishment.

Paragraph 1 applies irrespective of whether the right to tax is in fact exercised by the State of residence; and, thus, when the income arises in the other Contracting State, that State cannot impose tax even if the income is not taxed in the first mentioned State (*see* paragraph 3 OECD Commentary on article 21).

Other income - In the third State may escape taxation

27.4 Income arising in the third state may escape taxation. Allocation of the right to tax income under article 21 depends upon the determination of the residential status of the recipient in terms of the article 4. The domestic law of the states may consider a person resident in both. Article 4 decides the matter. Once the fiscal residence has been decided and the right to tax allocated to one contracting state, the other Contracting State withdraws its claim. This might lead to non-taxation situation. The income arising in the third state may escape taxation. The state which has the right to tax does not levy because the income arising to a person is not remitted there. The other state does not have the right, cannot levy on the ground that income has not suffered tax in the former. To prevent happening such a situation, some agreements grant rights to both the countries. For example, the treaty with Italy provides, "Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention may be taxed in both the Contracting States". In case double taxation occurs, the state of residence gives relief under provisions of article 23.

Other income - Income in the third State and the permanent establishment

27.5 Paragraph 2 is an exception to paragraph 1 for income other than immovable property. If a resident of one country has a permanent establishment or a fixed base in the other Contracting State and such income arising to him is effectively connected with such permanent establishment such income is taxable in the state of that establishment. It is not taxable by the state of residence, as provided in paragraph 1. This provision is relevant to deal with income not dealt with in any other article, *viz.*, income arising in the third state.

Paragraph 2 also covers the case where the beneficiary and the payer of the income are both the residents of the same Contracting State and the income is attributed to a permanent establishment which the beneficiary has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment is situated. State of Residence would, however, grant relief in case of double taxation (*see* paragraph 5 of the OECD Commentary on article 21).

Paragraph 2 also contains an exception. The exception is immovable property as defined in paragraph 2 of article 6. In that case, the State of situs has the primary right to tax. "Therefore, immovable property situated in a Contracting State and forming part of the business property of a permanent establishment of an enterprise of that State situated in the other contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient of the income is a resident. This is inconsistency with the rules laid down in articles 13 and 22 in respect of immovable property since paragraph 2 of those Articles applies only to movable of a permanent establishment" (*see* paragraph 4 of the OECD Commentary on article 21). Thus, even if immovable property is a part of a permanent establishment or fixed base in a Contracting State, that State may not tax if neither the situs of the property nor the residence of the owner is in that State.

Other income - Source State right

27.6 Paragraph 3 recognises the right of the source state. Its provisions are intended to permit the country in which the income arises to tax such income if its law so provides. This may however result in double taxation, as paragraph 1 recognises the right of residence state over such income. Double taxation is avoided in terms of article 23. In some cases paragraphs 2 and 3 may overlap. They would then produce the same result.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - CAPITAL

ARTICLE 22

CAPITAL

1. *Capital represented by immovable property referred to in article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.*
2. *Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.*
3. *Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*
4. *All other elements of capital of a resident of a Contracting State shall be taxable only in that State.*

(The Group decided to leave to bilateral negotiations the question of the taxation of the capital represented by immovable property and movable property and of all other elements of capital of a resident of a Contracting State. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.)

IntroductionIntroduction

28.1 Article 22 deals with the taxes on capital, which is the source of income. Income arising from the employment of capital has been dealt with in the foregoing articles (the capital what the owner turns to profit by keeping it in his possession which is an income yielding asset). Taxes on capital generally constitute complimentary taxation of income from capital. The principles which have been applicable in regard to taxation of income are also applicable, to taxation on its source, viz., the capital. The right to levy tax on income from immovable property, or from the movable property of the permanent establishment or of fixed base; or from ships or aircrafts, has been given to the State where the property or the permanent establishment (or the fixed base) or the place of effective management is situated, respectively in terms of article 6, 7 (14) or 8. Such States have been given rights to levy tax on the capital as represented by the immovable pro-property, movable property, ships or aircraft. Thus, taxation on capital constitutes complimentary taxation of income from the capital, as there is no separation of the right of a State to tax income as well as on capital. The State which is entitled to levy tax on income arising from the capital, is also entitled to levy tax on that capital.

The entire article, and the word 'capital' or reference thereto in article 2 has been placed between the brackets, with a footnote of the first page of the UN Model Convention that the words in square brackets are to be deleted if it is not intended to include in the convention an article on taxation of capital. Most of the Indian agreements do not contain article on taxation of capital and therefore, reference to 'capital' in article 2 is absent as also the article relating to 'Taxation of capital'. However, few agreements contain provisions relating to capital, viz., Finland and Sri Lanka.

Capital - Source State right to taxCapital - Source State right to tax

28.2 Paragraphs 1, 2, 3 first specify the property which is the subject-matter of article 22, as representing the immovable property, the movable property of the permanent establishment or the fixed base, the ships or aircraft or

the movable property pertaining to the operation of such ships or aircraft then define it, and thereafter confer rights to the State to levy tax on it where such property or the permanent establishment or the fixed base or the place of effective management of the enterprise of ships or aircraft is situated. Thus article 22 is complementary to earlier articles dealing income from various sources viz., immovable property, movable property, ships and aircrafts, and others.

Capital - Residence State right to tax

28.3 As regards other elements of capital not specified in the preceding paragraphs 1, 2 and 3, paragraph 4 provides that tax on such element is to be levied by the Contracting State of which the person to whom these belong is a resident.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - ELIMINATION OF DOUBLE TAXATION

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

ARTICLE 23A

EXEMPTION METHOD

- 1. Where a resident of a Contracting State derives income (or owns capital) which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income (or capital) from tax.*
- 2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of articles 10, 11 and 12, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.*
- 3. Where in accordance with any provision of this convention income derived (or capital owned) by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income (or capital) of such resident, take into account the exempted income (or capital).*

ARTICLE 23B

CREDIT METHOD

- 1. Where a resident of a Contracting State derives income (or owns capital) which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income-tax paid in that other State (and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State). Such deduction (in other case) shall not, however, exceed that part of the income-tax (or capital tax) as computed before the deduction is given, which is attributable, as the case may be, to the income (or the capital) which may be taxed in that other State.*
- 2. Where, in accordance with any provision of this Convention, income derived (or capital owned) by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income (or capital) of such resident, take into account the exempted income (or capital).*

Introduction

29.1 Article 23, deals with the methods for the elimination of double taxation, where the same income is taxable in the hands of the same person by more than one State. Double taxation occurs (a) when each Contracting State exercises its claim to tax its resident in respect of his worldwide income; or (b) one State exercises its claim on the basis that the taxpayer is its resident and the other on the basis that the source of income is situated within its territories. Article 4 has resolved the conflict as regards (a) when it has defined expression 'resident of a Contracting State' by referring to the tax liability of a person under the domestic laws of the respective States by reason of his domicile, residence, place of management or any other criterion of similar nature, and by listing of tie-breaking rules in case a person happens to be found resident of both the Contracting States in accordance with the aforesaid criteria. Since the taxability of the worldwide income is dependent on the residential status and the question about that status has been decided by rules of article 4, the occasion for double taxation on account of (a) above disappears. It has now got merged in (b). Solution in regard to (b) is found in articles (articles 6 to 22) relating to taxation of specific nature of income and by applying provisions of article 23A or 23B.

Articles 6 to 22 decide which of the two Contracting States is to withdraw its tax claims in respect of the type of income specified under these articles. The articles are the mechanism to avoid double taxation through the division of the two claims of the Contracting States and to provide for the computation of income. The object of each is specified in the first paragraph of the respective article, the nature of income, which thereafter reads 'shall be taxed only in....' or 'may be taxed in....' the State of the residence or the source. The subsequent paragraphs then define the income sought to be covered under the concerned article and how it is to be determined. The expression 'shall' implies imperativeness and wherever it is used along with the words 'be taxed in a State' it conveys that the other State will have to waive its tax claim. It implies exemption. Credit method of avoiding double taxation is not intended to be applied. 'May' is a permissive and enabling expression and when used along with the words 'be taxed in....' in the State of source it enables that State to tax it. The residence State, however, has not been precluded from taxing it. The consequence is that one has, therefore, to look upon article 23 of the Model for relief from double taxation. Thus, the article containing the expression 'shall be taxed in....' is a complete rule in itself so far as the tax claims of the Contracting States are concerned, whereas the article using the expression 'may' in place of 'shall' leave the problem relating to tax claims unresolved, for the solution thereof rule contained in article 23 has to be applied. Thus, the conflict as regards (b) is resolved where articles 6 to 22 have allocated the right to one of the Contracting States to levy tax on income as specified therein. Such allocation may be made by renunciation of the right either by the State of residence or of the source or of the situation of the permanent establishment or the fixed base or by sharing the right to tax between the two States. These articles together with article 23 govern such allocation.

Elimination of double taxation - Three methods

29.2 There are principally two methods for elimination of double taxation. The third method is the hybrid, between the two. These methods are known as :—

1. Exemption method;
2. Credit method;
3. Tax sparing.

The two methods have been laid down for the elimination of double taxation. Article 23A deals with exemption method; article 23B, credit method. Double taxation relief is achieved through exemption from tax granted by one country, or where income remains taxable in both treaty countries at either a full or reduced rate, by the country of residence of the recipient giving a tax credit, in respect of the tax paid in the source country. These two methods deal with a situation where the residence state and the source state retain concurrent rights to levy some taxation. That situation arises where the tax treaty has not assigned exclusive jurisdiction to either of them. The right to tax is given, sometimes, to the country where income arises, exclusively or by way of priority (*see* paragraphs 1 and 2 of article 8; paragraph 3 of article 13, sub-paragraph (a) of paragraphs 1 and 2 of article 19; and, paragraph 3 of article 22). In some other, the state of residence of the recipient has an exclusive right to tax (*see* first sentence of paragraph 1 of article 7; paragraphs 1 and 2 of article 8; paragraphs 3 and 6 of article 13, first sentence of paragraph 1 of article 14, first sentence of paragraph 1 and paragraph 2 of article 15, article 18; paragraphs 1 and 2 of article 19; paragraph 1 of article 21; and paragraphs 3 and 4 of article 22). The expression used is that income "shall be taxable only in". In other cases, both the resident and the source states levy tax. In the last situation, the source country limits its tax to certain maximum, whereas the residence state reduces its own tax on the same income according to the aforesaid methods. The basic aim of the tax treaty in avoidance of double taxation. It is

achieved by assigning exclusive right to taxation to either of the states for different categories of income by defining the jurisdiction and the residual principles in the agreement. When, however, the exclusivity is not possible and the conflicting claims are not reconciled and both states insist upon exercising their rights to levy taxation, double taxation results. With respect to certain types of income both the states retain the right; as for example, dividends, interest and royalties. Double taxation may result. The question of avoidance of this happening arises. It is done by employing either (a) the exemption method with progression (article 23A); or (b) the ordinary credit method (article 23B).

Tax sparing is a hybrid between the exemption and the foreign tax credit systems. Tax credit is allowed not only for foreign taxes actually paid but also for taxes the developing countries forgo through the application of the fiscal incentives. Such sacrifice of the revenue by the developing countries is popularly known as tax expenditure.

Elimination of double taxation - Exemption and credit method, distinction

29.3 The primary responsibility for relieving double taxation rests upon the residence state. It can exempt foreign source income, or it can allow credit for the foreign taxes paid. The basic distinguishing features between the two are:—

- The essential feature of the exemption method is that the residence state grants an exclusive right to the source state to levy tax. It does not levy any. Under the credit method it retains its right to tax the total income, but against the tax levied allows deduction of the tax paid in the source state;
- The characteristic of the credit method compared with the exemption method is that the residence state is not obliged to allow a deduction of more than the tax due in the source state;
- Under the credit method, the residence state treats the foreign tax within certain limitations as if it were tax paid to itself;
- Credit method relates to tax, while the exemption method to income.

Elimination of double taxation - Exemption method

29.4 Article 23A deals with the exemption method. Paragraph 1 has made residence state responsible to exempt from tax income or capital which, in accordance with the provisions of the tax treaty, may be taxed in the source State.

The principle of exemption may be applied by two main methods—

- (a) *Full exemption* - The income which may be taxed in the source State is not taken into account at all by the residence State when determining the tax to be imposed on the rest of the income ;
- (b) *Exemption with progression* - The residence State retains the right to take into account the income which may be taxed in the source State when determining the tax to be imposed on the rest of the income.

(see OECD Commentary, article 23A, paragraph 14)

The method generally is the exemption method with progression. The foreign income is not included in the income of the taxpayer by the residence state but is taken into account in determining the tax rate for other taxable income. Paragraph 3 enables the residence state retain the right to take into account the exempted income in determining the tax rate applicable to the remaining domestic income. Income derived as dividends, interest or royalties with respect to which the source state has withheld tax, there is no exemption. The state of residence may tax it. It, however, allows as a deduction from the tax on that income an amount equal to the withheld tax in the source state. Such deduction is not to exceed that part of the tax as computed before the deduction is given, which is attributable to such item of income as dividends, interest or royalties. Thus, paragraph 2 provides exception to the exemption method with regard to income derived as dividends, interest, royalties, fees for technical services. In that case double taxation is avoided by crediting the foreign tax.

Exemption method - Obligation of the State of residence

29.4-1 Paragraph 1 of article 23A provides that the State of residence shall exempt from tax income and capital which "in accordance with the provisions of this Convention" may be taxed in the State of source. The obligation arises only if the income is derived by its resident which—

- is in accordance with the provisions of the Convention,
- may be taxed in the source State.

The expression "in accordance with the provision of the Convention" is discussed later.

The expression "may be taxed" refers to the right of the source State to tax. Irrespective of whether or not the right has been exercised and income or capital in fact taxed, the obligation of the residence State to exempt is absolute. The exceptions are, however, provided in paragraphs 2 and 3. The OECD Commentary, article 23A, paragraph 34.1 provides:

"The obligation imposed on the State of residence to exempt a particular item of income or capital depends on whether this item may be taxed by the State of residence in accordance with the provisions of the Convention"

Thus, where the source State considers that it may tax an item of income or capital in accordance with the provisions of the Convention but no tax is actually payable under the provisions of the domestic law, the residence State must exempt that income. It is because that exemption in the source State does not result from the application of the provisions of the Convention but from the domestic law (*see* OECD Commentary, paragraph 56.2)

The expression "may be taxed" does not always impose obligation on the residence State to grant exemption, as in case of an income which is subjected to limited taxation as for example derived in accordance with provisions of articles 10 (dividend), 11 (interest), 12 (royalties). Paragraph 2 of article 23A provides for a credit for such limited tax.

Paragraph 3 of article 23A provides for the application of the exemption method with progression (discussed in para 29.4). The State of residence retains the right to take the exempted income or capital in calculating the amount of tax on the remaining of the income or the capital. This principle of progression applies to income or capital which under any provision of the Convention "shall be taxable only" in the other Contracting State (*see* OECD Commentary, paragraph 55)

Elimination of double taxation - Credit method

29.5 Article 23B deals with the credit method of elimination of double taxation. The state of residence allows deduction of the amount equal to taxes paid in the source state. Such deduction is not to exceed that part of the income tax as computed before the deduction is given, which is attributable to the income which may be taxed in the source state (paragraph 1). Paragraph 2 is similarly worded as paragraph 3 of article 23A. The credit of tax is given (1) in respect of taxes paid in the state of source which should be the amount of tax (2) on the income which in accordance with the provisions of the tax treaty may be taxed in that State.

The principle of credit may be applied by two main methods (OECD Commentary, paragraph 16) :

- Full credit* - Residence State allows the deduction of the total amount of tax paid in the other State;
- Ordinary credit* - The deduction given by the residence State for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State.

Under the credit methods, the residence State retains its right to tax the total income. But against the tax so imposed it allows deduction which may not be more than the tax due in the source State. Where the tax due in the source State is lower than the tax of the residence State appropriate to the income from the Source State (maximum deduction), the taxpayer will always have to pay the same amount of tax as he would have to pay if he were taxed only in the residence State, *i.e.*, as if his total income were derived solely from the residence State (*see* OECD Commentary, paragraph 25). Where it is higher, the taxpayer will not get deduction for the whole amount of the tax paid in the source State and its effect would have been the same as the method of exemption with progression (OECD Commentary, paragraph 27). The maximum deduction may be computed—

- by apportioning the total tax on total income according to the ratio between the income for which credit is to be given and the total income, or
- by applying the tax rate for total income to the income for which credit is to be given.

The maximum deduction is normally computed as the tax on net income *i.e.*, on the income from the source State less allowable deductions (specified or proportional) connected with such income.

The credit method is also applied in respect of income under articles 10, 11 and 12, as credit has to be given of the tax paid in the source State.

Elimination of double taxation credit method - Taxes paid in the source state

29.5-1 Article 23B allows credit with respect to the tax paid in the other state. That expression means only the amount of tax which has been paid and not due or payable or would have been payable. That amount, however, cannot exceed the residence country tax on the income to which the tax relates. Failing such a foreign tax credit limit, the excess tax arising could be offset against the tax on the domestic income, reducing residence country's revenue collection. Thus, foreign source income derived by a resident of a state is subject to that state tax upto an amount not exceeding the state tax payable thereon.

Elimination of double taxation - Tax paid on income-taxed in accordance with provisions of tax treaty

29.5-2 The credit of tax is given by the residence state in respect of the taxes paid on the income which in accordance with provisions of the tax treaty may be taxed in source state. The words "in accordance with" mean in agreement with or harmony with, in conformity to—*Nav Bharat Vanijya Ltd. v. CIT* [1980] [123 ITR 865](#) (Cal.). The expression in the context of taxation of income may mean taxability of income by the state in pursuance of the right given to it in the agreement, though the residence state may also have the right to tax it according to its own domestic laws. Articles 6 to 22 of a tax treaty deal with the taxation of income. Exclusive right has been given to one state in respect of an item of income. In respect of some other, both have the right. The question of elimination of double taxation arises in the latter case. The old Indian treaty with Great Britain [Notification No. GSR 612(E) dated 23-11-1981] defines the expression "in accordance with the provisions of this convention" inclusively as to include taxes which are the subject of the convention and imposed on income not expressly mentioned in this convention. Such taxes are to be given credit. Thus, only when is the tax paid on the income derived by the taxpayer which may be taxable in the source state, deduction is allowed. If the tax has not been paid or if the income is exempt in the residence state, deduction is not permissible. There are, certain items of income which are taxable in the source state such as those referred to in article 8, in paragraph 3 of article 13, sub-paragraph (a) of paragraphs 1 and 2 of article 19, paragraph 3 of article 22. There the expression used is "shall be taxable only" with reference to the type of income mentioned therein. It means that the income is taxable in the state of source. The state of residence has no right. Credit with respect to such paid taxes is not allowed in the state of residence.

In accordance with provisions of Convention - Classification of income

29.5-3 The residence State is required to provide relief in respect of an item of income taxed by the source State "in accordance with the provisions of the Convention", even if that income may be classified by the two States differently as per their respective domestic laws. (see OECD Commentary, paragraph 32.3). The Commentary illustrated in paragraph 32.4, by an example. A business is carried on through a permanent establishment by a partnership established in that State. A partner resident of the residence State alienates his interest in that partnership. The source State treats partnership as fiscally transparent whereas the residence State as a taxable entity. The source State considers the alienation an alienation of by the partner of the underlying assets of the partnership which may be taxed in accordance with paragraphs 1 and 2 of article 13. Residence State considers that the alienation is akin to the alienation of share in a company which could not be taxed by the source State by reason of paragraph 5 of article 13. In such a case, the conflict of qualification results exclusively from the different treatment of partnerships in the domestic laws of the two States. The source State must be considered by the residence State to have taxed the gain from the alienation "in accordance with the provisions of the Convention" for purposes of the application of the article 23A or article 23B. The residence State must therefore grant exemption pursuant to article 23A or give a credit pursuant to article 23B irrespective of the fact that, under its own domestic law, it treats the alienation gain as income from the disposition of shares in a corporate entity and that, if the source State qualification of the income were consistent with that of residence State, the residence State would not have to give relief under article 23A or article 23B. No double taxation would arise in such a case.

The residence State is bound by the source State classification even if it is not consistent according to its domestic law; but not when there is conflicting interpretation of the treaty. Dispute may arise about partnership carrying on the business through the fixed place and the source State so believing and taxing the income "in accordance with the provisions of the treaty" by applying paragraph 2 of article 13 thereof. The residence State considers that there is no such fixed place of business. The dispute may also arise about whether the assets formed "part of the business property" in paragraph 2 of article 13 and the residence State considers that they do not. In both the situations the

conflict is not on account of different interpretation of the domestic laws of the States but about source State taxing the income "in accordance with the provisions of the Convention" Such dispute could be resolved under article 25. (see OECD commentary, paragraph 32.5)

In the above illustration, suppose the source State treats the partnership as a corporate entity and the residence State as fiscally transparent. In that case, the source State cannot tax the alienation by reason of paragraph 5 of the article 13. Residence State considers that it is covered under paragraph 1 or 2 of that article and that it should have been taxable by the source State. It is neither taxable in the State of source nor in the State of residence. There is double non-taxation. In that situation, the State of residence is under no obligation to exempt the income (see OECD Commentary, paragraph 32.7)

Elimination of double taxation - Tax sparing

29.6 When the source state retains its right to tax, it is done because the activity which results in the generation of income is fully integrated in the economy of that State. It is generally accepted principle that the foreign resident should be subjected to the same conditions of activity, including taxation, as residents of the source state. Tax burden should be determined exclusively and definitely by the source state. The incentive measures of that state designed to promote economic activities should actually benefit the investor and is not nullified by taxation by the state of residence. The tax treaties, therefore, provide for the "fictitious" credit with respect to tax forgone by the developing countries so that the benefit is retained by the investor. Such credit is known as tax sparing. If the credit is given to the actual tax paid and not for the further tax which would have been payable in the absence of the incentive relief, the benefit which the developing country intended to confer on the concerned taxpayer could be nullified. The country's sacrifice of the revenue would ultimately accrue to the state of residence. In that case the entire benefit of the incentive would pass off to that state. The taxpayer cannot retain the benefit of exemption and will have to pass it to the state of residence. For him the outgoing is the same, whether it is or that state retains it. As for an illustration, if the tax liability in the state of residence is "X" but the person has paid the amount "Y" in the source state, his liability in the former state is $X - Y$ (Z). The effective liability in the state of residence depends upon the actual payment of tax in the source state *i.e.*, Y. If Y is increased, Z is correspondingly reduced. If it is reduced, Z is increased. The reduction in the amount of Y because of the incentive provisions of the source state would result in the corresponding increase in the Z. If Y is *nil*, Z will be equal to X. The beneficiary of the incentive is, therefore, not the person which is intended to receive it, but the state of residence. The incentive to make investment is lost. Foreign investment flow is effected, which the tax treaty intends to stimulate. For the encouragement of the flow, it is necessary to let the investor preserve to itself the tax incentives. This is done through the provision of "tax sparing" in the relevant tax treaty. Tax sparing means that credit is given not only for the tax paid but also further tax which would have been payable in the absence of the incentive relief. By this device the benefit which the developing country intends to conferring on the concerned taxpayer is not nullified.

Elimination of double taxation - Tax sparing an extension of regular tax credit

29.6-1 Tax sparing credit is an extension of the regular tax credit to taxes that are spared by the source country *i.e.*, forgiven or reduced with the intention of providing incentives for investment. Tax sparing refers to provisions in the tax treaty which protect incentives in the developing countries to encourage investment in those countries. It is a variant of credit method which goes beyond the credit method. It is a matching credit for tax spared, granted for a limited period. The country of residence will grant a credit not only for the tax actually paid but also for the tax that would have normally been imposed but which is not so done because of the tax incentives. "Indian tax payable" has been defined in some tax treaties as also to include the amount of income tax in accordance with the Indian tax laws but for the exemption or reduction of Indian tax in accordance with the laws relating to incentives for the promotion of economic development in India which are in force on the date of the signature of the agreement or any other provisions which may subsequently be introduced, in modification, or in addition to, these laws. The regular tax credit is a measure for the prevention of double taxation. The tax sparing credit extends the relief granted by the source country to the investor in the residence country and does not seek reciprocal arrangements by the developing countries.

Elimination of double taxation - Tax sparing - Tax payable

29.6-2 The application of the tax sparing provision demands that the credit is to be given not only to the taxes paid but also to those payable. Tax paid is deemed to include any amount which would have been paid if the tax had not

been exempted or reduced in accordance with the special incentive measures under the provisions of the domestic tax, which are designed to promote economic development. "Tax payable" is not the same thing as "tax assessed". It may mean tax which a person would have been assessed to pay, but for the exemption provided in the Income-tax Act. The word "payable" is used as an adjective to describe the quality or the nature of the tax which could have been due on the amount taxable under the charging section. The tax sparing is confined to the amount of tax which would have been payable as tax but for any relief by way of

- deduction allowed in computing taxable income;
- an exemption;
- a reduction of tax;
- or otherwise

under the laws relating to taxation of income in force in the contracting states. The expression "or otherwise" is used in some tax treaties along with some specified sections of their domestic tax laws. These words are not the words of limitation but of extension as to cover other cases which may not come within the preceding clauses (see *Lila Bai v. State of Bombay* AIR 1957 SC 521) and, thus, all possible ways of reduction in taxes.

The reduction in tax may be on account of or by way of relief. The reason for such relief may be varied. It may be to encourage a certain type of industry, or backward area, or to encourage export, or to encourage scientific research and development, or to attract foreign investment or technology etc. Exemptions and deductions under the Indian Income-tax Act may broadly be grouped as under :—

- Tax free income (sections 10, 10A and 10B)
- Deductions from gross total income such as development of backward areas, encourage export of goods or merchandise, services, tourism, development of infrastructure (sections 80C to 80U);
- Income forming part of total income on which no tax is payable (sections 86 and 86A).

Relief is also allowed if a person carrying on business or profession takes the advantage of the scheme of investment deposit account (section 32AB), investment allowance, development allowance, tea development account (section 33AB) etc. These provisions relate to relief and not to the expenditure incurred wholly or exclusively for the purpose of business.

Elimination of taxes, tax sparing - Two forms

29.6-3 Tax sparing credit may take two forms. Either the amount of credit corresponds to the ceiling rates agreed upon for purposes of source taxation or even surpasses the ceiling rate. The first form makes sure that further reduction of source below ceiling rates benefits the recipient. The second ensures furthermore that the tax sacrifice of the source country, towards the common goal of providing tax incentives, is met with a corresponding tax sacrifice by the state of residence.

Elimination of double taxation tax sparing - US treaty

29.6-4 The US objects inclusion of tax sparing provisions in their tax treaties as a matter of policy and as a matter of expediency. Objections on the ground of policy are two :—

1. US tax benefit should go to the residents of the partner country and not to its own residents;
2. Investment decisions should be governed by the market considerations and not by the tax considerations. Its policy is to foster capital export neutrality;

Matching credit for tax spared would conflict with both.

Objections on the ground of expediency are :—

1. The US system of taxing foreign income and in particular it allows the deferral of the US tax until the foreign profits are brought into the USA, would give much less extra relief to the US residents investing abroad if it provides matching credit than might be expected on the face of it, and the expedient would therefore be less effective than would appear on the surface.
2. Tax sparing credit in view of the US tax authorities encourages inefficient tax and development policies in tax sparing countries. Taxpayers should bring the profit home and then make re-investment in the developing countries.

3. According to the US tax authorities, there is no evidence that the tax holidays are of great importance in attracting capital.
4. According to the US tax authorities, there is no reason to give relief to investors in countries providing tax holidays than to investors in low tax countries which do not provide tax holidays.

Dividend exemption - Imputation system

Dividend exemption under imputation system

29.7-1 Domestic law of a State may exempt taxation of dividend paid by a company which has already paid tax on the profits which are distributed amongst the shareholders as dividend, to prevent taxation of income doubly. Under the classical system, which recognises the legal and independent existence of corporate personality as distinguished from the individual shareholder, corporate profits are taxed once in the hands of the company and thereafter also in the hands of individual shareholder on receipt of such profits as dividend. Under such a system, taxation of income in the hands of the shareholders does not affect taxation of the company's profits. This follows as a logical corollary to the separateness and the independent existence of a corporate personality as distinguished from the corporators.

This provision is relevant to system where relief is given to the shareholders on account of the tax already paid by the company, to mitigate double taxation. The imputation system avoids double taxation by exempting from taxation dividends in the hands of shareholders when the company has paid taxes on its profits. Though it is an admitted fact that this system does not render the company as an agent of its shareholders and it itself is chargeable to tax on its profits and pays tax in discharge of its own liability, the company is not chargeable with income-tax on dividends. It is not assessed in respect thereof. The reason appears to be this, that the amount which is available to be distributed as dividend has already been diminished by tax on the company and it is inequitable to charge it again, in order to obviate economic double taxation. Australia, UK, USA, New Zealand and other countries follow the imputation system. India has also been following it till 1960. Thereafter, it started following the classical system though the in-roads were made into it by sections like 80L, 80CC and 80M. Whatever the merits, non-resident shareholders with portfolio investments are relatively disadvantaged. Recipients of the dividends paid out of profits which have suffered corporate tax will not receive any imputation credit. Such shareholders are obliged to pay tax at a certain percentage as agreed upon in the treaty. Though such tax will have to be allowed as a foreign tax credit in their domestic tax assessments, the shareholders would find themselves as if they are subjected to classical system, unlike their domestic counterparts.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - NON- DISCRIMINATION

ARTICLE 24

NON-DISCRIMINATION

1. *Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of article 1 also apply to persons who are not residents of one or both of the Contracting States.*

2. *Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and*

connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. [Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.]

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State are or may be subjected.

6. The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.

IntroductionIntroduction

30.1 Article 24 deals with non-discrimination provisions; nationality non-discrimination, permanent establishment non-discrimination, and, deduction and ownership non-discrimination. It seeks to prevent discrimination of the "nationals", "residents" of other Contracting State carrying on business and "enterprises" owned by the treaty partners. It aims at ensuring to nationals of another Contracting State, residents of any third State, stateless persons, equality of treatment with the nationals of the Contracting State with regard to taxation and any requirement connected therewith. Discrimination is also sought to be prevented with regard to taxation on the permanent establishment, related and controlled companies, deductibility of expenses by way of interest, royalties and other disbursements for determination of taxable profits of an enterprise. Avoidance of discrimination consists in prevention of imposition by the State of liability which is more burdensome than the liability on its nationals in the matter relating to taxation and connected requirements.

Its basic tenet is outlined in paragraph 1. It is that nationals of a Contracting State should not be subjected by the other to any taxation requirement more burdensome than that which nationals of the other State in the same circumstances are subjected. Paragraph 2 deals with stateless persons who are resident of the Contracting States, and is similarly worded as paragraph 1. In contrast to nationality non-discrimination provisions, which prevents taxation which is other or more burdensome than the taxation and connected requirements to which the nationals are subjected, the permanent establishment non-discrimination provision (paragraph 3) requires that taxation should not be less favourably levied on a permanent establishment than on a resident. Connected requirements are not mentioned. Paragraph 4 is the deduction and paragraph 5 is the ownership non-discrimination provision. Ownership non-discrimination refers to discrimination based on the ownership of a similar enterprise, which is different from the other two types of non-discrimination. The one is based on "nationals in the same circumstances"; the other, on "enterprises carrying on same activities".

Non-discrimination - ObjectivesNon-discrimination - Objectives

30.2 The four objectives of the non-discrimination article are to prevent discrimination of the nationals, stateless persons, residents and enterprises of the treaty partners :—

1. Nationals of a Contracting State by another State with respect to any "taxation" or any "requirement connected therewith" which is more "burdensome" than the taxation and the connected requirements to which nationals of that other State in the "same circumstances" are subjected (Paragraph 1 of article 24, the expression "national" has been defined in paragraph 1(B) of Article 3),
2. Stateless persons in the same manner as in 1 above (Paragraph 2);

3. Residents of other State in two cases, both relating to business income, (a) permanent establishment (Paragraph 3), deduction in computing business profits of interest, royalties, and other disbursement (Paragraph 4),
4. Enterprises owned by treaty partner residents (Paragraph 5).

"Nationals and stateless persons" in the same circumstances, "residents" carrying on the same business activities through permanent establishment, similar "enterprises" owned by, of the other Contracting States are not to be discriminated by the taxing State with regard to any taxation to which its "nationals", "residents", and "enterprises" are subjected. Taxes of every kind and description are covered (Paragraph 6).

Discrimination - Meaning

30.3 Article 24 assures nationals of a Contracting State a non-discriminatory treatment. For the purpose of Article 24, non-discrimination means providing nationals (paragraph 1) and stateless persons (paragraph 2) will not be subjected to discriminatory treatment in the other Contracting State. It means that similar treatment obligation applies if the nationals or residents of the two States are comparably placed and that two persons similarly situated must be treated similarly.

Paragraphs of Article 24 are framed in negative form, indicative of imperativeness, enjoining the State to accord the same treatment to foreigners non-resident as accorded to its nationals placed in similar circumstances. The principal object is to forbid discrimination. There is however, nothing to prevent the State from granting to persons of foreign nationality, for special reasons of its own, or in order to complying with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals (*see* paragraph 9 of the OECD Commentary on Article 24). Discrimination means unequal treatment in situations which are identical or comparable. Article 24 is merely a specific enunciation of the general principle of equality. This principle requires that similar situations shall not be treated differently unless differentiation is objectively justified.

Differentiation does not mean discrimination

30.4 Differentiation does not mean discrimination, if there is justification. Article 24 does not militate against justified differentiation. What it holds is that similar situations should not be treated differently unless sustained on justification. Different treatment constitutes no discrimination when it is objectively justified or at least in economic matters not arbitrary -*Ruckdeschel v. Hauptzollamt Hamburg-St. Annen* 1979 2 C.M.L. R 445. Discrimination occurs if there is no reasonable argument. Staughton L.J. stated in *Berkeley Administration v. McClelland* [1990] 2 WLR 1021 (CA)

"Time was when to discriminate in English meant to differentiate on wise and discerning grounds; now it means often...to differentiate without such grounds".

Differentiation solely on account of nationality is sought to be prevented. Discrimination can be justified if it is based on different reasons than nationality or residence.

If the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared that difference is not to be treated as discriminatory. For example, if one person is taxable in a Contracting State on a worldwide income and the other is not, or tax may be collectible from one person at a later stage, but not from the other, distinctions in treatment would be justified.

Different but comparable tax treatment that reflects the different circumstances of a foreign owned and domestic owned businesses does not necessarily constitute discrimination against foreign owned businesses. The matter was discussed by the Authority for the Advance Rulings in *Advance Ruling Application No. P-16 of 1998, In re* [1999] [102 Taxman 377](#) (AAR- New Delhi). In that case the contention of the applicant, a non-resident French banking company, was that levy of higher rate of tax on non-domestic company was violative of article 26 of the DTA between India and France, as both were carrying on the same activities. It was rejected, as follows :—

"This argument is of little merit. The activities of the Indian and the French banks are similar in that both carry on banking operations. However, the activities of the Indian and the French banks are not identical. As we have noticed earlier, large banks are not identical. As we have noticed earlier, large Indian banks were nationalised by two Acts of Parliament to promote certain social and economic objectives of the State and have to function as instruments for mobilisation of resources of the common good. They cannot be said to be

in the same circumstances as French banks which have no such constraints and are free to operate their profit-making apparatus to the maximum extent possible. It has also to be borne in mind that a nationalised bank has to be treated as State under article 12 of the Constitution. Fundamental Rights can be enforced against a nationalised bank. It has also to comply with Government guidelines and laws in the matter of recruitment of its employees. A certain percentage of posts has to be reserved for the less privileged sector of the society regardless of the merit. In other words, their activities have to be in consonance with the directive principles of the State policy and cannot violate the fundamental rights of their employees or their customers in any manner. If the activities of a bank before and after nationalisation were the same, there would have been no justification for nationalisation of the large Indian banks.

Clause 2 of article 26 prohibits discrimination between Indian enterprise and a French enterprise carrying on the same activities. We are of the view that a French bank and a nationalised bank do not carry on the same activities".

Differentiation with justification does not therefore amount to discrimination.

Discrimination, and not the differentiation in the manner as discussed above, is sought to be prevented with regard to any taxation.

The operative paragraphs use different language to identify the kinds of difference in taxation that will be considered discriminatory. For example, paragraphs 1, 2, 5 speak about "any taxation or any requirement connected therewith which is other or more burdensome than the taxation to which the nationals of that other State in the same circumstances", while paragraph 3 specifies that a tax "shall not be less favourably levied". Irrespective of these difference in language, difference in the tax treatment that materially disadvantage the foreign person (namely, nationals, stateless persons, permanent establishment and foreign residents owning the domestic enterprise) relative to the domestic person are properly the subject of the Article. The terminology is different, perhaps, because the discrimination under paragraph 3 is based not on nationality but on the actual situs of the enterprise. The nationally discrimination is concerned with individual, legal entity, partnership, or association of persons who may be resident of one of the Contracting States; whereas, permanent establishment discrimination is concerned not with any of these but with the enterprise. The focus of paragraphs 1 and 2 is the resident person who is subjected to taxation which should not be more burdensome, and of paragraph 3 not the resident of the contracting State but the enterprise carrying on the activity the taxation of which shall not be less favourably taxed. In one case, it is the person and in the other, activity. In the nationality non-discrimination, the object of comparison is "nationals... in the same circumstances", while in the permanent establishment non-discrimination on "enterprises ... carrying on the same activities." Whether comparably situated, what is to be seen in the former whether the circumstances of the person are the same, and in the latter whether the activities are same. The object of both is the same, *i.e.*, there should not be differences in tax treatment of a foreign relative to domestic person or enterprise. Discrimination must relate to—

- any taxation or any requirement connected therewith which is
- other or more burdensome
- in the same circumstances; or
- tax shall not be less favourably levied.

With respect to foreign nationals, stateless persons, permanent establishments and foreign residents owning domestic enterprise.

All these aspects are discussed in the following paragraphs.

Non-discrimination - Any taxation, meaning and scope

30.5 Article 24 lists a number of circumstances requiring equal treatment with regard to :—

1. any taxation or any requirement connected therewith of treaty partner nationals (paragraph 1);
2. any taxation or any requirement connected therewith of stateless person of a treaty partner resident (paragraph 2);
3. any taxation levied on permanent establishment of a treaty partner resident (paragraph 3);

4. any taxation or any requirement connected therewith of an enterprise of a treaty partner resident (paragraph 5).

Paragraphs 1, 2, 3, 5, speak about non-discrimination with respect to "any taxation", and also with respect to "or any requirement" connected therewith. The expression "any" means all and every kind. It has been clarified in Paragraph 7. The word "taxation" as given in New Webster's Dictionary and Thesaurus (1992) is as under :

"The imposition of tax: the system by which taxes are imposed: the revenue obtained by imposing taxes"

The meaning as given in *Black's Law Dictionary* is "the process of taxing or imposing a tax". The discrimination against taxation, therefore, means the procedure by which the tax is imposed that is to say various steps taken to impose it - *Municipal Board, Hapur v. Raghuvendra Kripal* AIR 1966 SC 693. It means the formalities relating to returns, payment, prescribed times etc.

Non-discrimination - Taxation does not mean rate of tax

30.6 Taxation does not mean rate of tax. It is different from levy of tax itself. Paragraph 1 of Article 24 does not use the word "levy" at all. Paragraph 3, uses the expression "the taxation.....shall not be less favourably levied". Taxation levied on enterprise normally means, in the context of the Income-tax Act, levy of income-tax on the income of an enterprise. It merely means the entire process of imposing charge, assessment of tax as well as collection of charge. There is a difference between the tax and the imposition of tax. The former is the levy itself; and the latter, method by which the levy is imposed and collected. The charging section identifies the subject-matter. It creates liability to pay tax, as distinguished from the mode of assessment and the machinery by which it is assessed. The intrinsic character is not to be determined by the mode of measurement or the standard of calculation for assessing the amount of tax - *Ralla Ram v. Province of East Punjab* AIR 1949 FC 81 Taxation is concerned with the mode or standards. The charging section, the computation provisions, the collection procedure are all covered within the scope of the expression "levy". This expression is not used in paragraph 1. Even its meaning in the context of paragraph 3 does not place an embargo on imposing a higher rate of tax for the foreign concern than on the Indian concern - *Advance Ruling (Application No. P-16 of 1998, In re [1999] 102 Taxman 377* (AAR-New Delhi). As aforesaid the article uses the expression "taxation" and not the "tax". In some articles one is used, while in others, the other. They have different meaning and connotation depending upon the context, but are not interchangeable. The object clause of every agreement contains both, where the purpose is stated to be "avoidance of double taxation and prevention fiscal evasion with respect to taxes on income or wealth" (see for example, agreement with France). The expression "taxation" has been used in articles 24 and 25. Avoidance of discrimination is the object of the former; and avoidance of double taxation, of the latter.

As aforesaid, article 24 speaks generally of taxation. That means Indian tax provisions should not be more burdensome on a foreign resident nor will it place it in a more disadvantageous position than a similarly circumstanced Indian concern. Where rate of tax is the focus, the language used is the "tax so charged shall not exceed" the percentage so specified, as for example, with respect to dividend income, interest, and royalties. These are concessional rates.

Non-discrimination article speaks of taxation and not of rate of tax. Higher rate of tax with respect to income of a non-resident assessee than the rate with respect to income of a resident assessee does not attract the non-discrimination provision - *Advance Ruling Application No. P-16 of 1998, In re [1999] 102 Taxman 377* (AAR-New Delhi)

This is made clear in Article 26(2) of the DTA between India and United Kingdom of Great Britain. It provides

".....This provision shall not be construed as preventing a Contracting State from charging the profits of a permanent establishment which an enterprise of the other Contracting State has in the first-mentioned State at a rate of tax which is higher than that imposed on the profits of a similar enterprise of the first-mentioned Contracting State, nor as being in conflict with the provisions of paragraph (4) of Article 7 of this Convention".

The absence of specific rule of interpretation as provided in the UK agreement in any other agreement cannot be construed to mean that the enterprise of a foreign company cannot be taxed in India at a higher rate than the rate at which an Indian company has to pay tax. Such an absence does not lead to conclusion that the same rule of construction will not apply. The UK agreement clarifies that the non-discriminatory clause should not be construed as a bar to the imposition of a higher rate of tax on a foreign company.

The Indian Income-tax Act, 1961 clarified in the *Explanation* below section 90, which reads as follows:

"For the removal of doubts, it is hereby declared that the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company, where such foreign company has not made the prescribed arrangement for declaration and payment within India, of the dividends (including on preference shares) payable out of its income in India"

What divides a foreign company and an Indian domestic company is the declaration and payment of dividends in India. Domestic company means an Indian company, or any other company, which, in respect of its income liable to tax under the Indian Income-tax Act, has made arrangements for the declaration and payment, within India, of dividends (including dividends on preference shares) payable out of such income (section 2(22A) of the Indian Income-tax Act, 1961). Thus, a foreign company would be treated as Indian domestic company if it has made the such arrangements for declaration and payment of dividends in India as mentioned above.

Non-discrimination - Connected requirements of taxation

30.7 The expression "connected requirements" of taxation means the formalities connected with taxation, such as returns, payments, prescribed time, etc. It, therefore, means the manner and the method of procedure for determination of the tax and its recovery, and all other formalities connected with the taxation and assessment. No discrimination is made in regard thereto, between the national and the foreigner, if the circumstances of both are the same. But the circumstances are not the same as regards enforcement and collection methods. The difference justifies discrimination - *In R v. IRC ex p. Commerz-bank* [1991] STC 271 (QBD), the absence of requirement to repayment supplement (interest on tax repayment) in the United Kingdom, which is not paid to non-residents, was held to be more burdensome connected requirement.

Non-discrimination - Three kinds

30.8 The non-discrimination dealt with in article 24 is of three kinds :—

1. Nationality non-discrimination (paragraphs 1 and 2);
2. Permanent establishment non-discrimination (paragraphs 3 and 4);
3. Ownership non-discrimination (paragraph 5).

Non-discrimination is with respect to taxation of any kind. In case of 1 and 3 above, it should not be more burdensome; and in case of 2, it should not be less favourably levied.

Non-discrimination on the ground of nationality

30.9 A nationality non-discrimination provision first appeared in a model tax treaty in the OEEC first report of 1958, which referred to the existence of such provision in other commercial treaties. The OECD commentary on the 1977 OECD Model refers to its use in the 19th century treaties of friendship or commerce. Paragraph 1 of Article 24 of the OECD/UN Model prohibits discrimination on the ground of nationality. It provides that nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation to which the national of that other State in the same circumstances are or may be subjected.

This provision applies also to the persons who are not residents of one or both of the Contracting States, but must be nationals of either. Stateless persons who are residents of the Contracting States are also not to be similarly discriminated (paragraph 2). The expression "nationals" has been defined in paragraph 1(b) of Article 3.

Nationality, meaning

30.9-1 Paragraph 1(b) of Article 3 defines the expression "nationals" as to mean all individuals possessing the nationality of a Contracting State; and also all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

A legal relationship involving allegiance on the part of an individual to a State is termed nationality. It is the character or the quality arising from membership of some particular nation or State, which determines the political status and allegiance of a person. It may be acquired by birth, descent, naturalisation, conquest or cessation of territory, or (if a woman) by marriage (see A Concise Law Dictionary by P.G. Osborn).

The definition in paragraph 1(b) of Article 3 includes legal persons deriving their status from the laws in force of the Contracting State. Some Indian treaties define "nationals" similarly (Belgium, Hungary, Japan, Korea, Libya, Malaysia, Singapore). The treaty with USA confines to "individuals". A third State of agreements, like the one with UK have left the term undefined. In that case, it has to be interpreted in the context of the other provisions of the DTA itself. Paragraph 1 of the non-discriminatory article 26 of the DTA with UK, deals with nationals, paragraph 2 deals with enterprises and enunciates a rule of non-discrimination against them which is restricted only to enterprises having a permanent establishment. If the expression "nationals" includes companies and other associations as well, the special provision regarding enterprises in paragraph 2 would not have been necessary at all. Secondly, it is significant that article 4 of the said agreement refers to nationality only with reference to individuals. "In the light of these features of the present agreement, it is legitimate to construe the double taxation agreement as prohibiting discrimination, (a) in the case of individuals, and (b) in the cases of enterprises, (other than individuals) only where they have their permanent establishment in India and not otherwise"—No. P/6 of 1995, In re [1998] 234 ITR 371 (AAR) in the context of DTA between India and UK.

The expression "national" has been defined in the OECD Model Convention to mean any individual possessing the nationality of a Contracting State, any legal person, partnership or association deriving its status as such from the law in force in a Contracting State. Thus, individuals, legal persons, partnership and association are covered under the definition of "national". The OECD Commentary, paragraph 11, states :

"In view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a separate provision, but to assimilate them with individuals under paragraph 1. This result is achieved through the definition of the term "national" in sub-paragraph n(f) of paragraph 1 of Article 3."

30.9-1a NON-DISCRIMINATION - NATIONALITY AND CITIZENSHIP, DISTINCTION - "Nationality" and "citizenship" are not interchangeable terms. Nationality has reference to the jural relationship which may arise from consideration under international law. On the other hand, citizenship has reference to the jural relationship under municipal law. In other words, nationality determines the civil rights of a person, natural or artificial, particularly with reference to international law - *State Trading Corporation v. CTO* AIR 1963 SC 1811. A person is subjected to civil rights and duties, that is capable of having rights and of being liable to duties. Persons are of two kinds; natural or artificial. A natural person is a human being. An artificial person is a collection or succession of natural persons forming a corporation. Paragraph 2, therefore, refers to both. It is more specific as to legal persons. Partnerships and associations are included. If an artificial person has acquired status in a State according to its domestic laws, it is national of that State as an entity with that status. In defining the nationality of companies, certain States, regardless of the law which governs the company look to the origin of the capital with which the company is formed or the nationality of the individuals or legal persons controlling it.

30.9-1b NON-DISCRIMINATION - NATIONALITY AND RESIDENCE, DISTINCTION - Nationality is also different from fiscal residence which has reference to taxability under the domestic income-tax laws, of the world wide income of a person from all sources. In case of an individual, it is normally determined on the basis of his physical presence in the country during the prescribed period and in the case of a company, its incorporation under the laws of, or the situation of the control and management of its affairs in, that country (*see* for example, section 6 of the Indian Income-tax Act, 1961).

Residence is thus the basis of taxation of a person's global income, even though in some countries, such as the United States, nationals are taxed in this way without describing them as residents. Some countries deem their nationals as residents, as in the case of companies. In India, an Indian company is taxed as its resident. Other company is also similarly taxed if the control and management of its affairs is situated wholly in India. There is no difference between nationality or domicile or where the company has its registered office. The State of incorporation is regarded as the domicile of the company, rather than its nationality - *Egyptian Delta Land and Investment Co. Ltd. v. Todd* 14 T.C. 119 (HL). A company may have multiple nationality but one domicile, the location of its head office - (*Arab Monetary Fund v. Hashim* [1991] 2 WLR 729 (HL)). The Arab Monetary Fund had been incorporated in 21 countries).

Non-discrimination - Stateless persons

30.9-2 Paragraph 2 of the article is a prohibition on discrimination against a particular class of residents, insofar as it applies to the residents of another State. A stateless person is a person who is not considered as a national by any

State under the operation of its laws. Such a person but is resident of either of the Contracting States is entitled to equality of treatment with nationals of a Contracting State with regard to taxation or any other requirement connected therewith. Thus the scope of paragraph 1 is extended to stateless persons who are residents of either of the Contracting States. Stateless persons must, therefore, be residents of one of the treaty States to benefit from the non-discrimination provision. Such a requirement is meant to prevent stateless persons who are not resident in either State from being privileged compared to nationals of the other State, as they could otherwise claim freedom from discrimination in both States. A legal person cannot be stateless, as it derives its status from its incorporation under some system of law.

Non-discrimination - Nationality alone should not be the ground

30.9-3 The right against discrimination is not confined to nationals alone who are residents of a Contracting State, but extends to all nationals of each Contracting State, whether or not they are residents of either State but instead be residents of the third State Nationality. If nationality is not the ground, prohibition does not work. Article 24 does not prohibit discrimination against non-resident, if it is not based on nationality. In fact under the Indian Income-tax Act, a large number of concessions are given to a foreign companies, which are not available to Indian companies. An Indian company pays tax on its total world income whereas a foreign company is liable to pay tax only in respect of income which accrues or arises in India. Section 115A contains special provisions for tax on dividends, royalties and technical services fees in case of a foreign company. Special concessions have been given to non-resident sportsmen. Sections 115-O, 115P, 115Q are applicable to domestic companies. Surcharge imposed by the annual Finance Act is payable only by the domestic company.

Nationality may not be the reason for discrimination in some other circumstances, such as :—

1. Denial of imputation to tax credit to non-residents by the countries adopting this system (The discrimination is based on residence and not on nationality);
2. Discrimination based on residence of the person's employer, or of an insurance company to which the premium is paid;
3. Discrimination based if the other domestic laws than the tax laws so require.

This is further made clear by the OECD 1992 Model. It inserted words "in particular with respect to residence" after the words "in the same circumstances" in paragraph 1 of article 24 of the 1977 Model. In India there is a distinction between the Indian and a foreign company. It is based with regard to distribution of dividend. If a foreign company declares and distribute dividends in India, it has to be treated as a domestic company and taxed as such. "The basis of distinction between an Indian and a non-domestic company is quite clear. The object of tax Act is to collect tax. The dividend distributed in India lead to a fresh accrual of income in the hands of the recipient. That means that there will be further levy of income in the hands of the recipient" - *Advance Ruling Application No. P-16 of 1998, In re* [1999] [102 Taxman 377](#) (AAR-New Delhi). (This logic is no longer valid as dividend in the hand of recipient is not taxable. The discrimination could, however, be justified on the ground that if the domestic company has made arrangements for the declaration and payment of dividend in India, it has to be burdened with an extra tax liability representing 10 per cent of the amount thus distributed). A foreign company which distributes dividends in India is treated as domestic company and will pay the same rate of tax as the Indian company which declares and distributes dividends in India. Thus, distribution of dividends distinguishes, and not the nationality, to make it clear that residence of the taxpayer is one of the factors that are relevant in determining whether the taxpayers are placed in the similar circumstances. A taxpayer who is resident of a Contracting State and one who is not a resident of that State are not in the same circumstances. Thus, a national of a Contracting State should not be discriminated as against the national of the other State with regard to taxation and connected requirements, if they are "in the same circumstances" and be subjected with "other and more burdensome taxation".

Non-discrimination - Taxation of every kind

30.9-4 For the purpose of taxation discrimination on the ground of nationality is not permitted. If the circumstances of the national of a Contracting State are the same as those of the national of the other Contracting State, the latter will not impose liability on that national which is more burdensome than what its national would have been subjected to. The liability relates to taxation and the connected matters. For that matter taxes covered are not only those as mentioned in provisions of article 2, but also others of every kind and description.

Non-discrimination - In the same circumstances

30.9-5 Reference to "in the same circumstances" is inherent in the concept of non-discrimination. The word "same" carries the connotation of uniformity, of exactness in comparison. The phrase does not ordinarily mean in roughly similar circumstances : it means in substantially identical circumstances - *CIR v. United Dominions Trust Ltd.* [1973] New Zealand Tax Cases (N.Z.T.C.) 61,028. Substantial and not the complete identity between the circumstances of two persons is the criterion. Mathematical preciseness is not possible. Identity of facts, identity of circumstances, identity of claims, identity of disputes, are impossible to achieve. The circumstances are the same, if these are substantially similar both in law and fact, *i.e.*, if they correspond each other resembling in many respects barring a general likeness. The expression 'in the same circumstance's refers to taxpayer is placed, from the point of view of application of ordinary taxation laws and regulations, in substantially similar circumstances both in law and fact. It refers to general differences in circumstances, sparing and not excessive or extensive. The expression "same" may be read as "analogous" or "similar" in order to prevent negating the non-discriminating provision on the ground of minor differences. It may assist in making comparison where the legal and factual circumstances of the two taxpayers are slightly, and not very, different. Comparison between a resident and a national of State and a national of another State who is taxed in the same way as resident is impossible, as observed by the Court of Appeal in the New Zealand in - *CIR v. United Dominions Trust Ltd.*'s case. The Court dealt with a U.K. Company paying the higher non-resident rate of tax on interest derived from New Zealand otherwise than through a permanent establishment. The Court stated that a company incorporated and managed outside New Zealand could never be in the same circumstances as New Zealand company which was taxed on the basis of nationality. Under the domestic law, while a New Zealand incorporated company could be managed and controlled in the United Kingdom, and therefore, taxed there as resident, it would still be a New Zealand resident (very similar to Indian tax laws). A U.K. incorporated company managed and controlled in the United Kingdom would not be a New Zealand resident. Their circumstances are not the same. The contrary argument, that the only difference between the two companies was their nationality, was described as superficial. Since the expression "same circumstances" includes "residence" also, the discrimination on residence basis cannot be said to be discrimination on the ground of nationality. Thus companies incorporated and resident in a treaty partner state do not benefit from the same reliefs in the taxing State as companies incorporated there and taxed as residents. There is no reason for them to receive such allowances as they are not being taxed as residents. The issue is whether the circumstances are the same. They are not, except where the dual residence article can be applied so that both companies have the same residence for treaty purposes. Discrimination on account of nationality, rather than residence, is prohibited. Nationality non-discrimination provision is to prevent discrimination against nationals as such. The treaty definition dealing with dual residence of a company is of no relevance.

30.9-5a IN THE SAME CIRCUMSTANCES - FACTORS FOR DETERMINATION - The expression "in similar circumstances", as mentioned in the preceding paragraph, refers to taxpayers placed in substantially similar circumstances both in fact and law, from the point of view of application of ordinary taxation laws and regulations. Residence of the taxpayer is one of the factors that are relevant in determining whether the taxpayers are placed in the same circumstances as is clear from the qualifying expression "in particular with respect to residence" used in paragraph 1. Nationality should not be the ground of discrimination; all taxpayers irrespective of nationality be treated similarly and not differently. Two persons who are residents of the same State are not to be treated differently solely by reason of having a different nationality. Circumstances being not similar, the discrimination could be justified. OECD Commentary, paragraph 4, explains that State is not obliged to give the same treatment:

"... if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, the State cannot be obliged to give nationals of the other State who do don't reside in its territory the same treatment as it gives its resident nationals who reside in the other State."

Two persons may not be in the same circumstances with respect to their residence. For example, a national of a Contracting State (State R) who is also a resident of State R and a national of the other Contracting State (State S) residing in third State. The former may be taxed less favourably than the latter in State S, for instance, as a result of the application of provisions aimed at discouraging the use of tax havens (*see* OECD Commentary, paragraph 4).

A State is not obliged to extend the same privileges which it accords to its—

- ◆ its own public bodies or services (OECD Commentary, paragraph 5) ;
- ◆ private institutions not for profit whose activities are performed for purposes of public benefit (OECD Commentary, paragraph 6).

The discrimination is justified by the fact of the public bodies and services being integral part of the State, and by the nature of the private institutions' activities and also by the benefit which the State and its nationals derive from such activities (*see* OECD Commentary, paragraphs 7 and 8). Those circumstances and of the public bodies and services and the private institutions of other State are not comparable.

A taxpayer who is resident and one who is not are not in the same circumstances. The same tax regime cannot be applied to them. Residents are taxable on worldwide income, non-residents are not.

Non-discrimination - Other and more burdensome taxation

30.9-6 The expression "Other and more burdensome taxation" refers to "other taxation" and "more burdensome taxation". The word "other" is an alternative to the word 'more burdensome'. The expression "other taxation" means tax different from that to which nationals are subject. - *Woodend Rubber Co. v. CIR* [1971] A.C. 321 (PC) and the expression "more taxation", to the quantum of tax. The two together mean that, while there is nothing to prevent the taxing State from charging nationals of the other State less of the same tax, it cannot charge a different tax, or the same tax on a different occasion. This is clarified in *Woodend Rubbers'* case. In that case, UK Treaty with Ceylon was considered by the Privy Council. The Ceylon tax in question was a branch profits tax measured by reference to (rather than on) the remittances made out of the permanent establishment State, amounting to one-third of the remittances to a maximum of one-third of the taxable income. Resident companies on the other hand, paid an additional tax equal to one-third of the dividends paid, which was deductible from the dividends. This was in the form of an additional tax on the profits of the company, rather than a withholding tax on the dividends. Since the resident companies did not pay tax on remittances abroad, the tax was an "other" tax which was prohibited by the residence (as it was in that treaty) non-discrimination provision, even though the charge to tax was all part of income tax. The argument of the tax authority was not accepted that it was the same tax, income tax, as was paid by resident companies, and that it was also imposed on profits, so that it could not be an "other" tax.

Non-discrimination - More burdensome and not the favourable or concessional treatment is sought to be prevented

30.9-7 What is forbidden is the discrimination with regard to "taxation or any requirement connected therewith which is other or more burdensome". It means when a tax is imposed on nationals and foreigners in the same circumstances—

- it must be in the same form as regards both the basis of charge and the method of assessment,
- its rate must be the same,
- the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for the foreigners than the nationals. (*See* OECD Commentary, paragraph 10).

What is prevented is a more burdensome treatment to a foreigner *vis-a-vis* a national. But the grant of a concessional treatment or less burdensome or more favourable benefits or some other concessions or facilities to a foreigner or an enterprise of another State is not prohibited. If a country chooses to accord such favourable treatment or a benefit, the choice is not discrimination. In doing so the State may be influenced by many considerations, such as, import of technology or services or capital for its economic development or to comply with special stipulations in a double taxation agreement. It may grant relief to its nationals on account of family responsibilities. It may grant privileges to its own public bodies or services. In fact public bodies or services are integral part of the State and their circumstances are not comparable to those of the public bodies or services of another State. Circumstances being not the same, benefit or the privileges given cannot be discriminatory, if they are not extended to them. But such concession if granted to public sector companies or bodies which have been engaged in carrying out trading, commercial or gainful activities, would amount to discrimination if such a benefit is not extended to a foreign company or body similarly placed.

Non-discrimination - Nationality non-discrimination and Indian taxation

30.9-8 The system of taxation in India does not make a distinction between the nationalities of the taxpayers. Distinction is, however, made between a person resident in India as defined in section 6 of the Income-tax Act, 1961 and a person who is non-resident. A foreign national may be resident and an Indian national may be non-resident. Article 24(1) will apply very rarely. Therefore, the possibility of the requirements connected with taxation

being more burdensome for a foreign national than the requirements to which any Indian national may be subjected is non-existing. In the Advance Ruling in *No. P/6 of 1995, In re* [1998] 234 ITR 371 (AAR) which case related to UK Company, it was observed:—

"However, for the purpose of paragraph 1 of article 26 (non-discriminatory article of the DTE between India and UK), a comparison has to be made between persons similarly placed in respect of nationality and residence. The applicant is a company incorporated in UK, therefore, its case has to be compared with a non-resident company which is owned and managed by Indian nationals. Under the Income-tax Act, both the companies will be treated similarly and would be subjected to the same rate of taxation and the same requirements. To elaborate, section 44BB and section 115A(1) (of the Indian Income-tax Act, 1961) deal with non-resident assessee. Such persons may be Indian and foreign nationals but the concessional treatment under these sections will be available to both. Likewise section 44D and section 115A(1) and (2) deal with foreign companies which again may be run by Indian or foreign nationals. For instance even if the appellant had been a company formed by the Indian nationals and registered outside India, the provisions of section 44D and section 115A(2) would operate against it in the same manner."

There are many provisions in the Indian Income-tax Act, 1961 specially applicable to foreign companies. Likewise, there are very many provisions which apply to Indian or domestic companies only. The differentiation is based on residence as defined under section 6 of the Act. It is not based on nationality. Section 44D contains provisions for computing income by way of royalties etc. in the case of foreign companies. Section 44BB provides provision for computation of profits in the case of non-residents engaged in the business of supplying plant and machinery etc., for extraction/production of mineral oils. Likewise, there are special provisions for computation of profits for operation of aircrafts (section 44BBA), profits from shipping business (section 44B), computation of profits from turnkey power projects (section 44BBB), deduction of head office expenses (section 44C). There are also special exemptions available to a foreign company under section 10(6A) and 10(6B). Section 115A contains special provisions for tax on dividends, interest and penalty in the case of foreign companies. There are certain several provisions which have been made applicable to Indian companies alone. Deductions are allowable to Indian companies or a person (other than a company) under sections 80HHB (profits and gains from projects outside India), 80HHBA (profits and gains from housing projects), 80HHC (profits retained for export business), 80HHD (earnings in convertible foreign exchange from the business of a hotel a travel agent), 80HHE (profits from export of computer softwares). Chapter XII-D (Sections 115-O to 115Q) contains special provisions relating to tax on distributed profits of domestic companies.

There are many other sections which are specifically applicable to Indian companies or domestic companies. For example, section 80M (since omitted by the Finance Act, 1997, w.e.f. 1-4-1998) dealt with the situation where income by way of dividends from a domestic company is received by another domestic company (a domestic company means an Indian company or any other company which, in respect of its income liable to tax under the Indian Income-tax Act, 1961, has made the prescribed arrangements for the declaration and payment within India, of the dividends payable out of such income). Section 80-O deals with Indian company whose income includes any income by way of royalty, commission, fees or any similar payments from foreign Government or enterprise. Section 80AA (Omitted by the Finance Act, 1997, w.e.f. 1-4-1998) dealt with the computation of deduction under section 80M in respect of dividends from a domestic company.

It could, thus, be inferred that in the absence of any words of limitation, the provisions of the Act are applicable to any company, including a foreign company. Such an inference was drawn by the Authority for Advance Ruling in *P. No. 14 of 1997, In re* [1998] 234 ITR 335 (AAR), while considering the question of applying the provisions of section 115J relating to taxation of "zero tax companies". Under the Indian Income-tax Act, 1961, no discrimination is made on the ground of nationality. Differentiation is made on the basis of residence in the stated circumstances.

Further, the Act has limited the scope of discrimination. Section 90(2) gives an option to an assessee to whom the Indian tax treaty applies to be governed by the provisions of the Act to the extent they are beneficial to him.

Non-discrimination - Permanent establishmentNon-discrimination - Permanent establishment

30.10 Paragraph 3 of article 24 is a provision intended to prevent certain type of discrimination against residents, as opposed to nationals, of treaty partner States. It obliges a Contracting State not to exercise discrimination between its own enterprise and the permanent establishment of a foreign enterprise carrying on the "same activities", in the matter relating to taxation so that "taxation is not less favourably levied". Paragraph 3 provides—

1. The taxation on permanent establishment which an enterprise of a Contracting State has in the other State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.
2. It shall not be construed as obliging a Contracting State to grant resident of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own nationals.

The principle of non-discrimination or equal treatment set forth in (1) above is that the taxation of permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on the enterprises of that State carrying on the same sector of activities (*see* OECD Commentary, para 21). As regards the application of that principle to an individual resident having a permanent establishment in the other State, the conditions are set forth in (2) above. In its absence, that individual would be entitled to benefit of personal allowances and reliefs for family responsibilities in the State of the permanent establishment by virtue of equal treatment and also in his own State of which he is resident because of its domestic law. The benefits and reliefs were to be allowed in both the States and thus conferring greater advantage than the residents of the other State. For ensuring equality of treatment, this has to be denied. (*see* OECD Commentary, paragraph 22). Therefore if the PE State denies such benefit to the foreign individual resident, there would be no discrimination. Paragraph 350 of the Technical Explanation explains :

"This provision, however, does not obligate a Contracting State to grant to a resident of the other Contracting State any tax allowance, reliefs etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if a sole proprietor who is a resident of the other Contracting State has a permanent establishment in the United States, in assessing income-tax on the profits attributable to the permanent establishment, the United States is not obligated to allow to the resident of the other Contracting State the personal allowances for himself and his family that he would be permitted to take if the permanent establishment were a sole proprietorship owned and operated by a U. S. resident, despite the fact that that the individual income-tax rate would apply."

Thus if the State grants personal allowance, relief and reductions for taxation purposes to its residents because of their civil status or family responsibilities, the State is not obliged to extend those benefits to the residents of the other State. Liabilities under the Income-tax Act are no incident to ordinary civil rights - *LIC of India v. Asia Udyog (P.) Ltd.* [1984] 145 ITR 520 (Delhi)(FB).

Non-discrimination - Permanent establishment and nationality - Distinction

30-10-1 Nationality non-discrimination provision prevents taxation or any requirement connected therewith which is other and more burdensome. Permanent establishment non-discrimination requires that taxation should not be less favourably levied; connected requirement is not mentioned. Another point of distinction lies in the circumstances and the activities. "Same circumstances" is the requirement of the nationality non-discrimination; while the "same activities", of the permanent establishment non-discrimination. Thus, in the former the object of comparison is the "same circumstances", in the latter, carrying on the "same activities".

Non-discrimination - Permanent establishment, nationality is not the focus

30.10-2 The focus for preventing discrimination has been shifted from nationality to the actual situs of an enterprise. If once the existence of the permanent establishment is established, the nationality of the person of which it is the permanent establishment is of no relevance for claiming parity with the domestic enterprise which has been carrying on similar activities, with regard to taxation matters connected therewith. The condition precedent for claiming such parity is that both enterprises are engaged in carrying on of the same activities.

Non-discrimination - Carrying on the same activities

30.10-3 The words "carrying on the same activities" are referable to the nature of the activities. If the nature of the activities happen to be same, the income arising to a permanent establishment from such activities as also from other industrial and commercial activities should not suffer detriment more than what a domestic enterprise suffers. Carrying on the same activities means the same type of business. Whether two or more business activities be regarded as the same or different activities, depends upon the nature of the activities, the nature of the organisation, management, and a host of other related circumstances which stamp them as the same business activities.

Comparison factor should have been the "same circumstances" as in the nationality non-discrimination. Complete identity between the activities is not contemplated. Substantial similarity is the consideration. The similarity should be so close that distinctness is lost and there is no feature in any of the activities to make it distinct from the other. The standard is the common man. If he is unable to make distinction between two sets of activities and find no distinct change if one is replaced by another, the activities could be said same. Same activities mean reasonably similar rather than strictly identical. Circumstances of the permanent establishment and the domestic company may differ; otherwise, the comparison factor should have been the "same circumstances" as in the nationality non-discrimination. The purpose of the provision is to end all discrimination belonging to the same sector of activities, as regards taxes based on business activities, and specially taxes on business profits.

Non-discrimination - Taxation less favourably levied

30.11 Under article 24, what has to be seen is that a foreign national is not subjected to any tax to which an Indian national is not subjected. It has also to be seen that the law generally does not place an Indian company at a more advantageous position. The expression "taxation shall not be less favourably levied" means, in the context of the Indian Income-tax Act, levy of income-tax on the income of an enterprise, that the charging section and the computation section should not be so drafted as to place a foreign company in a less favourable position than the Indian company carrying on the same activities - *Advance Ruling Application No. P-16 of 1998, In re* [1999] [102 Taxman 377](#) (AAR-New Delhi), and that a tax should not be imposed upon a foreign company from which an Indian company is immune. Thus non-discrimination provision is primarily concerned with the computation of income; and not with the rate of tax. Both should come equally under the tax levied by the Income-tax Act; and there is no special tax on a foreign company. A good example of such a situation is provided in case of - *Woodend (K.V. Ceylon) Rubber & Tea Co. Ltd. v. IRC* [1970] 2 All ER 801, where the Privy Council had to deal with a case where under the law of Ceylon, a taxpayer company whose head office was situated in UK, had to pay additional tax in respect of its profits earned in Ceylon. The Ceylon tax was a branch profits tax measured by reference to, rather than on, the remittance made out of the income of the permanent establishment, amounting to one-third of the remittances to a maximum of one-third of the taxable income. Resident companies on the other hand paid an additional tax equal to one-third of the dividends paid, which was deductible from the dividends, this was in the form of an additional tax on the profits of the company, rather than withholding tax on the dividends. Since the resident companies did not pay tax on remittance abroad, the tax was "other" tax. The Privy Council so held. It held that since the additional tax was other taxation, it was prohibited by the residence non-discrimination provision, even though the charge to tax was all part of the income-tax. The contention of the authority was rejected, that it was the same tax (income-tax) as was paid by the resident companies, and that it was imposed on profits so that it could not be the "other" tax. However, the levy of this additional tax was ultimately held as tax on undistributed profits since it was a tax on profits, whether distributed or not, measured by remittance.

The Privy Council held—

- (a) The "remittance tax" is no way higher or more burdensome within the meaning of Article XVIII (of the Treaty between Sri Lanka and UK entered into in 1950).
- (b) The "remittance tax" is nevertheless "other taxation" within the meaning of Article XVIII in that resident companies are not subjected to tax on their remittance abroad. There was, therefore, conflict between the Income-tax law as amended in 1959 and the 1950 Treaty. The Privy Council decided that the later Act should take precedence over the earlier Treaty.

Non-resident companies were made liable to pay remittance tax notwithstanding the fact that it was "other taxation". This is a case of treaty override.

The principle of equal treatment though ensures availability of all deductions, rebates, allowances which are normally allowed in the computation of income of a business enterprise does not always hold good with respect to exemption, rebates and deductions allowed as incentives for the development of economically backward areas, or for the economic development of the country or for encouraging exports. Such benefits could be extended to the permanent establishments of a foreign enterprises, if such establishments agree to fulfil all conditions which are precedent to their grant. Likewise, discrimination provision which is applicable with regard computation provision, cannot be extended to the rate of tax. Forty eight per cent of tax on the permanent establishment and thirty five per cent (additionally ten per cent on the distributed profits) on the domestic company, under the Indian laws cannot be held discriminatory.

Permanent establishment-equality of treatment - Adaptation of mode of taxationPermanent establishment-equality of treatment - Adaptation of mode of taxation

30.11-1 A permanent establishment is subject to the domestic tax only on the income attributable to it, while the domestic enterprise engaged in the same activities is taxable on its worldwide income is not, in itself, a sufficient difference to deny equal treatment to the permanent establishment. There are cases where, however, the two enterprises are not similarly situated and the difference in treatment may be warranted. A foreign enterprise may be required to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available as from a domestic enterprise. One more important aspect of differentiation is that the permanent establishment is not a separate legal entity but only a part of the enterprise that has its head office in another State. Domestic enterprise constitutes a single entity all of whose activities are brought within the purview of the State. Thus, the situation of the permanent establishment is different from the domestic enterprise. Paragraph 20 of the OECD Commentary makes it clear that the phraseology of paragraph 3 recognises the practical difference between taxing a local resident company and taxing a permanent establishment of foreign company. It says "it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied." In paragraph 23, it says :

" . . . it was difficult to define clearly and completely the substance of the principle of equal treatment and this fact has led to wide differences of opinion with regard to many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. . . ."

The Commentary, thereafter examined the implications of equal treatment clause under several aspects of leaving of tax, viz., assessment of tax; special treatment of dividends received in respect of holdings owned by permanent establishment ; structure and rate of tax; withholding tax on dividends, interest and royalties received by a permanent establishment ; credit for foreign tax; extension to permanent establishment of the benefit of double taxation convention concluded with third States.

Permanent establishment - Assessment aspect of equality of treatmentPermanent establishment - Assessment aspect of equality of treatment

30.11-2 As regards assessment aspects, the implications of equality of treatment are :

- Permanent establishment must be accorded the same right as resident enterprises to deduct the trading expenses that are permitted under the taxation laws, including proportionate overhead head office expenses ;
- It must be accorded the same facilities with regard to depreciation and reserves;
- It must have the same right as is available to carry forward or backward a loss brought about at the end of an accounting year;
- It should have the same rules applied to resident enterprises, with regard to taxation of capital gains;

There is no difficulty with regard to equality of treatment in so far as the above rules. Difficulty arises with respect to incentive measures. Such measures are adopted for development of economically backward regions or the promotion of new activities necessary for the expansion of economy, by providing tax incentives or other tax advantage as an incentive for the enterprise to make investment. The permanent establishments may take advantage of such incentives if they fulfil the same conditions and requirements as resident companies. Refusal or inability to fulfil the conditions or requirements may result in denial of the advantage. The non-resident enterprises are, however, not entitled to tax advantage attaching to activities the exercise of which is strictly reserved to domestic enterprises, on the grounds of national interest, defence, protection of national economy etc.

Non-discrimination provisions - Deduction of interest and royaltiesNon-discrimination provisions - Deduction of interest and royalties

30.12 Paragraph 4 is designed to prevent discrimination as regards deductibility of amounts paid as interest, royalties and other disbursements by an enterprise to the residents of the other Contracting State, for the purpose of determining the taxable profits. There should be no discrimination on the basis of the recipients of such

disbursements being a resident and non-resident, unless it could be found that because of the close relationship between the enterprise and non-resident recipient, the transactions are arranged as to avoid payment of taxes and thus transacted under the circumstances which call for application of paragraph 1 of article 9, paragraph 6 of article 11 or of article 12. These provisions of these articles permit the denial of deductions in certain circumstances in respect of transactions between related parties.

A State may however, treat interest as dividends under its domestic laws rules on thin capitalization insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of article 11 (*see* OECD Commentary, article 24, paragraph 56).

Non-discrimination - Other disbursementNon-discrimination - Other disbursement

30.12-1 Paragraph 4 also prohibits discrimination in the allowance of other deductions, besides interest or royalties. The term "other disbursement" is understood to include reasonable allocation of the executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expenses (*see* paragraph 355 of the Technical Explanation on US Model Convention).

Ownership non-discrimination provisionOwnership non-discrimination provision

30.13 Paragraph 5 forbids discrimination of an enterprise on the basis that its capital is owned or controlled wholly or partly, directly or indirectly, by residents of the other Contracting States. This, therefore, ensures non-discrimination and not to look upon the persons who own or control the enterprise. Equal and identical treatment for the taxpayers residing in the same State is the object of paragraph 5. The object of comparison is the "similar enterprise". In the nationality non-discrimination, it is on "nationals...in the same circumstances", while in the permanent non-discrimination, on "enterprises... carrying on the same activities." "Similar enterprise" is roughly equivalent to "same activities" in the permanent non-discrimination provision. Some of the treaties, therefore, use the expression "carrying on the same activities". "Similar enterprise" may also mean enterprises in similar circumstances in law and fact. Some of the Indian treaties use the expression "in the same circumstances and under the same conditions", as for example treaty with Malaysia (1976). It would mean that the comparison is with resident-owned companies. Ownership of a non-resident means a change in circumstances and conditions. In India no capital gain tax is charged on transfer of assets of an Indian company owned by a parent Indian company. But it is done, if it is owned by a foreign parent. The enterprise is not similar, in that assets are removed from the Indian taxing jurisdiction when the parent is foreign. Therefore, "similar enterprise" means enterprise in similar circumstances, *i.e.*, similar activities or ownership of the enterprise.

Paragraph 5 relates to ending discrimination with respect to taxation of enterprises and not of persons owning or controlling their capital. Its object is, therefore, equal treatment for taxpayers residing in the same State, and not to subject foreign capital in the hands of the partners or shareholders, to identical treatment to domestic capital (*see* paragraph 57 of the OECD commentary on Article 24).

Non-discrimination and taxes coveredNon-discrimination and taxes covered

30.14 Paragraph 6 provides that the non-discrimination provisions applies to taxes of every kind and any description. It is notwithstanding article 2 which describes the taxes covered by a tax treaty. The scope is thus, extended very wide. All types of taxes levied by the State's political sub-divisions and local authorities, are also covered. Tax substitutes are, however, not covered which may be given by way of Government grant. Tax reliefs are similarly not covered. Such reliefs used to implement Government programmes are increasingly being referred to as tax expenditures, in part to ensure that they are subject to similar budgetary control procedures as are other Government expenditure.

DOUBLE TAXATION AGREEMENT - MUTUAL AGREEMENT PROCEDURE

ARTICLE 25

MUTUAL AGREEMENT PROCEDURE

- 1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.*
- 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.*
- 3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.*
- 4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.*

IntroductionIntroduction

31.1 The mutual agreement article of a tax treaty is designed to provide a mechanism for resolution of disputes concerning taxation where a disagreement exists between two Contracting States. The only article specially dealing with application of a tax treaty is 25. It institutes a mutual agreement procedure for resolving difficulties arising out of the application and interpretation of the treaty. The fact that a tax treaty has been concluded does not necessarily preclude the eventuality of double taxation occurring on account of its provisions being interpreted differently. The competent authorities of the Contracting States are under obligation to attempt resolution through the device of mutual agreement.

The aim of a Government in entering into an agreement with the other State is to gain acceptance for the objectives demonstrated as desirable and to realise them as fully as possible. Making a convention is only a means to achieve the purpose, viz., avoidance of double taxation and prevention of fiscal avoidance so that there is free flow of technology and capital between the countries. These objectives can be attained by the Governments concluding agreements. But many topic or subjects falling within the scope of these objectives could not be perceived at the time of drafting the convention without divine prescience and may, therefore, arise subsequent to the ratification. Situations may also change subsequent to such ratification. Many topic or subjects of the convention may require expertise, technical knowledge and a degree of adaptability to changing situations. The convention, therefore, delegates powers to the competent authorities of the respective Governments to attempt and to agree to a solution through mutual agreement, to the problem arising out of difficulties or doubts as to the interpretation or application of the convention or to the matters relating to the elimination of double taxation in cases not provided in it. The contractual process for the convention would bog down if the Government were required to appraise before hand the myriad situations to which it wishes a particular policy to be applied and to formulate specific provisions for each situation. The presence of the article 'mutual agreement procedure' in every convention is a pointer to the necessity of extensive delegation to some authority described as competent authority.

To achieve the two basic objectives, *viz.*, (a) avoidance of double taxation and thereby elimination of tax barriers to international trade and investment, and, (b) prevention of international tax evasion, the double taxation agreements seek to—

- mediate between competing jurisdictional bases for income taxation, between the source and residence;
- to develop common framework for certain basic concepts necessary to the application of the agreements, such as determination of residence and entitlement of benefits ; and
- to establish mechanism for resolving inter-State disputes as well as elimination of potential double taxation.

In the course of implementation of a double taxation agreement, some issues relating to the following may arise which require resolution though some mechanism either by the competent authority of the resident State or by the mechanism of mutual agreement of both the Contracting States:

- residence of taxpayer;
- withholding tax;
- net income taxes.

How this mechanism works is provided in Article 25.

Paragraph 1 of article 25 permits a taxpayer to seek mutual agreement where it considers that actions of the Contracting State may result in taxation not in accordance with provisions of the tax treaty. It is reactive procedure when a taxpayer approaches for resolution. Paragraph 2 enjoins the competent authority of the resident State to arrive at a satisfactory solution and in case of its inability, to resolve by mutual agreement with the competent authority of the other Contracting State. The agreed solution is implemented irrespective of any time limits in the domestic law. Paragraph 3 provides a more general power facilitative of the general problems before they affect the individual taxpayers. Paragraph 4 empowers competent authorities to develop appropriate bilateral procedures conditions, methods and techniques for the implementation of the mutual agreement procedure provided in the preceding paragraphs.

There are three kinds of situations which require resolution by mutual agreement :

- (1) taxpayers are subjected to taxation not in accordance with the provisions of the convention;
- (2) problems relating to interpretation or application of the convention;
- (3) double taxation not provided in the convention.

The authority of the resident State shall make endeavour to resolve the first (paragraphs 1 and 2) ; and authorities of both the Contracting States shall so do with respect to the second and may consult together with regard to the third (paragraph 3). Paragraph 4 deals with the practical operation of the mutual agreement procedure.

Mutual agreement procedure - Not a substitute to remedies under the domestic laws

31.2 The article lays down procedure for resolving difficulties arising out of the acts of the taxing authorities which in the opinion of the taxpayer do not conform to the intent express or implied of the double taxation agreement between the two Contracting States. Such a procedure is not a substitute to the remedies available under the domestic law for redressal of the grievance, but is in addition to them. The aim and purpose of the introduction of this article appears to be, to save a taxpayer from the lengthy and expensive procedure of litigation under the domestic laws and their uncertainties.

The commentary on the OECD/UN Model makes it clear that this procedure is in addition to and not in substitution of the remedies in the domestic courts or tribunals. This article could be invoked in addition to any legal form of appeal in the country concerned. [Simon's Taxes P. 163 (F. 1.263).] The German Federal Supreme Tax Court 1-2-1967, 1220/64 [B. St. B.1 1967/11 495] quoted in *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) (AP) has held that the existence of the 'mutual agreement procedure' does not prevent the court from proceeding with the case. The same view has been taken by the Swiss Federal Tribunal 17-3-1967 BGE 931-489, quoted in *CIT v. Visakhapatnam* case (*supra*). Even where the taxpayer initially invokes the mutual agreement procedure and in case the said authorities fail to agree or their agreement is not satisfactory to taxpayer, there will be no objection to the taxpayer then moving the courts, within the prescribed time, if any. In Canada and the United States, the view is entertained that taxpayers should protect their rights of appeal before the courts while applying for mutual

agreement procedure. The Andhra Pradesh High Court in *CIT v. Visakhapatnam Port Trust* [1983] [144 ITR 146](#) is of the view that the article underlines a procedure which is in addition to and not in substitution of the remedies before the domestic courts or tribunal and the taxpayer may rely upon the agreement before the domestic tribunal. Therefore, the taxpayer is entitled to seek the remedies available under the domestic laws of the States, besides taking the matter with competent authority. If a taxpayer has already taken up the matter with the competent authority and also taken it up with a tribunal under the domestic law, and their decisions are at variance with each other, the decision more favourable to the taxpayer should be implemented. The agreement or the decision is exclusive and is not influenced by the other as regards its implementation.

Mutual agreement procedure - Special procedure outside the domestic law

31.2-1 Mutual agreement procedure is special procedure outside the domestic laws and it could be made to swing into action only if the objection relates to the incorrect application of the provisions of the agreement in relation to taxes and persons covered under the agreement, to determination of fiscal domicile, to the existence of a permanent establishment or to the computation of business income or its allocation or attribution to the permanent establishment, to the objection about discrimination *vis-a-vis* the nationals of the States, to the taxability of income by States which the other State has exclusive right to tax under the agreement and that State under its domestic law cannot exercise that right, and so on. When a charge of tax has been or is proposed to be made in contravention of the domestic laws and also of the agreement the former is outside while the latter is within the scope of this article. The objection is amenable to the mutual agreement procedure only to the extent that the agreement is affected, unless the contravention of the domestic law is intimately linked with its contravention. Unlike under the domestic law, redressal of objection under this procedure could be sought even when the proposed action of the taxing authority, in the opinion of the taxpayer, does not accord with the agreement which if allowed to culminate in an order will result in taxation not intended by the agreement. Only in cases coming within paragraph 1 of the Article 25, it could be resorted to, *i.e.*, in cases where tax has been charged or going to be charged, in disregard of the provisions of the convention. Where a charge of tax has been made contrary both to the convention and the domestic law, the case is amenable to the mutual agreement procedure to the extent only that the Convention and the rules of the domestic law which have been misapplied (*see* paragraph 7 of the OECD Commentary on Article 25).

Mutual agreement - Reactive procedure

31.3 Paragraph 1 permits the taxpayer to seek mutual agreement where he considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of the tax treaty, by presenting his case to the competent authority of the State of which he is resident (or national, if his case comes under paragraph 1 of article 24) within three years from the notification of the said action. Upon receiving a request for assistance if the competent authority of the resident State believes that the facts justify assistance, it may arrive at a satisfactory solution. It may deny if the applicant:—

- is not its resident unless the tax treaty provides otherwise;
- is not entitled to the treaty benefits;
- does not cooperate with it by providing relevant information and record.

The competent authority may consult with the competent authority of the other State, though it is not necessary. The taxpayer is not to participate in the process.

The participation is limited to co-operating with the competent authority by providing relevant information or records.

The case is presented to the competent authority—

- where actions of the State result or will result in taxation not in accordance with the convention ;
- by the taxpayer who is its resident (unless his case comes under paragraph 1 of Article 24) ;
- within three years for the notification of the said action.

No form or rule has been provided for doing so.

Mutual agreement procedure - Actions of the State

31.3-1 The term "actions" mean all acts or decisions, whether of a legislative or a regulatory nature, and whether of general or individual application, having as their direct and necessary consequence on the charging of tax against the complainant contrary to the provisions of the convention (*see* paragraph 12 of OECD commentary). Such action, and not of the taxpayer's own, should result in double taxation. That action may have not been taken as yet and the taxpayer notified. He may still present the case to the competent authority if he could establish that the "actions of one or both the Contracting States" will result in taxation which is not in accordance with the Convention and this taxation appears as a risk which is not merely possible but probable (*see* para 12 of the Commentary).

Further, the requirement laid on the taxpayer to present his case is of general application, regardless of whether the taxation objected to has been charged in that or the other State and regardless of whether or not it has given rise to double taxation, and also regardless of his change of residence if he had been resident of that State in the year in respect of which taxation has been or going to be charged (*see* paragraph 14 of the OECD Commentary on Article 25). The mutual agreement procedure mechanism is meant for the resolution of inter-governmental disputes concerning taxation under the relevant tax treaty. Action of the State should lead to double taxation, as for example, transfer pricing where transactions are not at arm's length, disallowing excessive royalties and interest charged to permanent establishment, or disallowing claim of deduction of executive or administrative expenses recharged by the parent company located in another State. If the double taxation is the consequence of the taxpayer's action, the mechanism of mutual agreement will not be available.

As regards the nature of dispute which is to be referred to the competent authority, the Technical Explanation on the US Model observes in paragraph 368, as follows (paragraph 1 of Article 25 of the US Model is similarly worded excepting that there is no time limit and the presentation could be made to either of the competent authority) :

"Although the typical cases brought under this paragraph will involve economic double taxation arising from transfer pricing adjustments, the scope of this paragraph is not limited to such cases. For example, if a Contracting State treats income derived by a company resident in the other Contracting State as attributable to a permanent establishment in the first- mentioned Contracting State, and the resident believes that the income is not attributable to a permanent establishment, or that no permanent establishment exists, the resident may bring a complaint under paragraph 1 to the competent authority of either State."

Disputes which are covered mainly relate to questions :

- where the measure in question leads to double taxation which it is the specific purpose of the Convention to avoid. Among the most common cases, mention may be made of the following (*see* paragraph 8 of the OECD Commentary on Article 25) :
 - the questions relating to attribution to a permanent establishment of a proportion of the executive and general administrative expenses incurred by the enterprise, under paragraph 3 of Article 7;
 - the taxation in the State of the payer - in case of special relationship between the payer and the beneficial owner - of the excess part of interest and royalties, under the provisions of Article 9, paragraph 6 of Article 11 or paragraph 4 of Article 12;
 - cases of application of legislation to deal with thin capitalisation when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to Article 9 or paragraph 6 of Article 11;
 - cases where lack of information as to the taxpayer's actual situation has led to misapplication of the convention, especially in regard to the determination of residence (paragraph 2 of Article 4), the existence of a permanent establishment (Article 5), or the temporary nature of the services performed by the employee (paragraph 2 of Article 15);
- where one State taxes a particular class of income in respect of which the Convention gives an exclusive right to tax to the other State and that State is unable to exercise it owing to a gap in its domestic law, though no double taxation is involved (*see* paragraph 11 of the OECD Commentary) ;
- where a person who being national of one of the Contracting State but resident of the other State is subjected in another State to taxation treatment which is discriminatory under the provisions of paragraph 1 of Article 24 (*see* paragraph 11 of the OECD Commentary).

Mutual agreement procedure - No form prescribed for presentation of a case

31.3-2 No form has been prescribed for the presentation of the case. In its absence the form as prescribed by the domestic law for presentation of a similar case may be followed. Whatever the form, it must essentially disclose how an act of a State has resulted or will result in taxation which is not in accordance with the agreement, and on what basis and how the taxpayer considers the aforesaid or proposed action contravening the agreement and what in his opinion should be the correct interpretation and such contravention having the effect of fastening unintended liability, as also that his case falls within the scope of the article.

Mutual agreement procedure - Time limit presentation of a case

31.3-3 The presentation of case should be made within three years to be reckoned from the date of the action(s) of one or both the Contracting States which in the opinion of the taxpayer will result or has resulted in taxation not in accordance with the convention. If the taxability is effected by a series of actions or combination of decisions the period of three years will run from the latest of them or the most recent. The running of the limitation commences when the concerned person becomes aware of the action taken or proposed to be taken which will have adverse effect on him and not from the date when he forms his opinion about such adverse effects.

The interpretation of the term "three years" should be done liberally, in favour of the taxpayer. The time limit runs from the date of the notification of the individual action giving rise to the said taxation, from the act of taxation itself, as evidenced from the notice of assessment or an official demand or other instrument for the collection or levy of tax. For example, if the tax is levied by deduction at source, the time limit begins to run from the moment when the income is paid or from the later date if taxpayer proves his knowledge of deduction on that date.

Mutual agreement procedure - Competent authority - How resolves the case

31.3-4 A reading of paragraphs 1 and 2 of Article 25 suggests two stages for the resolution of dispute; one, presentation by the taxpayer to the Contracting State of which the applicant is resident, and, second, resolution by that Contracting State itself and if unable by mutual agreement with the other Contracting State. The first stage of the procedure is the presentation of the case to the competent authority of the State of which the taxpayer is the resident. That authority on receipt is obliged to determine whether the objection *prima facie* is justified. If it is so found on such determination, it would attempt an appropriate solution if it is possible to be arrived at by itself. In a case the issue could be resolved by mutual agreement with the competent authority of the another State, endeavour should be made. Resolution of the difficulty should aim at avoidance of taxation which is proposed to be or has been imposed, not in accordance with the agreement. The limitation laid down in the domestic law, if any, is not a bar for the implementation of the agreement. The implementation could also not be influenced by any adverse decision of the appellate authority or the domestic court if the taxpayer has already taken up the matter with that authority or the court under the domestic law. Pendency of litigation in the domestic court or tribunal is not a bar for the taxpayer to resort to the remedy under the article, nor does the decision of that court or tribunal adverse to him. Proceedings for the redressal of grievance under this article or under the domestic laws are independent of each other and are not mutually exclusive. It is open to the taxpayer to resort to either of the two proceedings according to its efficacy or according to his convenience and need. Though the competent authority can grant relief under this article even if the domestic court/tribunal has given decision adverse to the assessee in the proceeding also initiated by the taxpayer, yet it may be bound under the Constitution of its country to abide by that decision as any act contrary to it tantamounts to contempt of court, the competent authority may then request the authority of another Contracting State to grant relief. This is possible only when the issue arises wholly or in part on account of the measures taken in that other State. The process of mutual agreement could be set in motion when the measures taken by both the Contracting States, each asserting its right to tax, affects adversely the taxpayer.

The application of the taxpayer to set the mutual agreement procedure in motion should not be rejected without good reasons. Paragraph 23 of the OECD Commentary on Article 25 reads as follows:

"A taxpayer is entitled to present his case under paragraph 1 to the competent authority of the State of which he is a resident whether or not he may also have made a claim or commenced a litigation under the domestic law of that State. If litigation is pending, the competent authority of the State of residence should not wait for the final adjudication, but should say whether it considers the case to be eligible for the mutual agreement procedure. If it so decides, it has to determine whether it is itself able to arrive at a satisfactory solution or

whether the case has to be submitted to the competent authority of the other Contracting State. An application by the taxpayer to set the mutual agreement procedure in motion should not be rejected without good reason."

Mutual agreement procedure - Endeavours of the competent authorities

31.4 The second stage, after the competent authority has found merit in the taxpayer's presentation, is to find a satisfactory solution. There are two forms for doing so; the competent authority itself endeavours to find satisfactory solution; and, second, if unable to do by itself, to resolve by mutual agreement with the competent authority of the other Contracting State.

If the competent authority of the State is satisfied that the taxation complained of as not being in accordance with the provisions of the Convention, is due to measures taken in that State, it must give satisfaction by making such adjustments and reliefs as appear justified. At this stage agreement with the competent authority of other Contracting State is not required. It may, however, be consulted, if need be, in order, for example, to confirm a given interpretation of the convention.

Inability to arrive at a satisfactory solution would arise if the taxation complained of is due wholly or partly due to a measure taken in the other State. In that case, there is need for mutual agreement with a view to avoidance of double taxation. For example, for determining adjustment due to transfer pricing adjustments, as per paragraph 2 of the Article 9, consultation with each other is necessary.

Paragraph 2 provides that if competent authority of the resident state is not able itself to arrive at a satisfactory solution, it shall make an endeavour to resolve by mutual agreement with the competent authority of the other State. Any agreement reached shall be implemented notwithstanding any time limits in the domestic laws of the States. Endeavour means effort, which may not culminate in solution. The paragraph entails a duty to negotiate. It does not oblige to reach a solution. The negotiation does not guarantee a result. The word "any" in last sentence of the paragraph (which reads as "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States) in the context means if". Thus the bar of limitation prescribed by the national law will not be applicable to an agreement if any reached.

The article is not a complete answer to the difficulties of a taxpayer. The competent authorities are required to make an attempt but not obliged to arrive at a solution. There is likelihood of the provisions of the tax treaty being interpreted or applied differently in the two Contracting States and the competent authorities not agreeing to a solution. Double taxation may persist which the treaty aims at avoiding. Arbitration appears to be the solution based on equity considerations, as pointed out in paragraph 27 of the OECD Commentary on Article 25 which reads as follows:

"In seeking mutual agreement, the competent authorities must first, of course, determine their position in the light of the rules of their respective taxation laws and of the provisions of the Convention, which are as binding on them as much as they are on the taxpayer. Should the strict application of such rules or provisions preclude any agreement, it may reasonably be held that the competent authorities, as in the case of international arbitration, can, subsidiarily, have regard to considerations of equity in order to give the taxpayer satisfaction."

Mutual agreement procedure - No bar for the implementation of the agreement

31.4-1 The time limit in the national laws of the Contracting States is not an impediment in the implementation of the agreement if mutually decided. Normally such time limit relates to assessment and adjustment of tax refunds. The agreement shall have to be implemented irrespective of limitation of time in the domestic laws of in regard to matters which are subject matter of agreement.

Mutual agreement procedure - Adverse court decision

31.4-2 The taxpayer may make a presentation to the competent authority, notwithstanding of his having made a similar complaint to the domestic court for the redressal of his grievance. The competent authority is bound to decide if it finds merit in the presentation, without waiting for the court's adjudication. But before it decides, the court's decision is available which is adverse to the taxpayer, the question arises whether the competent authority may not feel bound by and depart from that decision. One view is that the competent authority may not be bound by the decision of the court while implementing the provisions of the Convention, on the ground that the latter overrides the domestic law in case of conflict (as discussed in Chapter 3) and the competent authority is an

authority under the Convention and acting thereunder in the implementation of its provisions. The other is that every authority falling within the jurisdiction of the court, be it administrative or judicial, is bound by it and the competent authority is not an exception. The answer is found in paragraph 24 of the OECD Commentary on Article 25, which reads as follows:

"If a claim has been finally adjudicated by a court in the State of residence, a taxpayer may wish even so to present or pursue a claim under the mutual agreement procedure. In some States, the competent authority may be able to arrive at a satisfactory solution which departs from the court decision. In other States, the competent authority is bound by the court decision. It may nevertheless present the case to the competent authority of the other Contracting State and ask the latter to take measures for avoiding double taxation."

In case, however, suit is pending in the court, the competent authority, in order to avoid head on collision with the possible adverse decision, may make implementation of a mutual agreement subject to :

- the acceptance of such mutual agreement by the taxpayer, and
- the taxpayer's withdrawal of his suit at law concerning the points settled in mutual agreement.

Mutual agreement procedure - Proactive for removal of difficulties and doubts

31.5 Paragraphs 1 and 2 relate to the resolution of individual case which according to the taxpayer has resulted or would result in taxation not in accordance with agreement. The process is set in motion at the initiation of the individual. The starting point is the presentation of his case made by the taxpayer to the competent authority of the State of which he is the resident. Paragraph 3 relates to difficulties and doubts of general nature arising about the interpretation or application of the agreement, or to the elimination of double taxation in cases not provided in the tax treaty, and how this purpose could be achieved. Such difficulties, doubt or matters about avoidance of double taxation may concern a category of taxpayers though come to the surface when the treaty is applied to an individual case. It, therefore, provides a more general power that might be termed proactive - facilitating the solution of general problems before they affect individual taxpayers. This power provides the mechanism to follow through the implementation of article 10 (dividends), article 11 (interest), and article 12 (royalties), paragraph 2. That paragraph provides, "The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation". Thus article 25 makes it possible to resolve difficulties of a practical nature which might arise in connection with the setting up an operation of procedures for the relief from tax deducted from dividends, interest or royalties. The main object and the purpose of a tax treaty are to avoid double taxation. The difficulties may also be those which could impair or impede the normal operation of the clauses of this Convention as they were conceived by the negotiators, the solution of which does not depend on a prior agreement as to the interpretation of the Convention. The treaty may be insufficient to prevent so happening in all cases. The purpose is achieved if the agreement is supplemented by a protocol like the treaty itself subject to ratification or approval.

Mutual agreement procedure - Difficulties and doubts - Some instances

31.5-1 As foresaid the competent authorities are authorised to resolve some difficulties or doubts that may arise as to the application or interpretation of the Convention. The US Model Convention gave a list of examples of the kind of matters about which the competent authorities may reach agreement. Paragraph 3 of Article 25 of that Model Convention reads as follows (corresponding to paragraph 3 of the UN/OECD Model Convention) :

"The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement may difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree :

- (a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;
- (b) to the same allocation of income, deductions, credits, or allowances between persons;
- (c) to the same characterisation of particular items of income, (including the same characterisation of income that is assimilated to income from shares by the taxation law of one of the Contracting States and that is treated as a different class of income in the other State;
- (d) to the same characterisation of persons;

- (e) to the same application of source rules with respect to the particular items of income ;
- (f) to a common meaning of term;
- (g) to advance pricing arrangements; and
- (h) to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the convention.

They may also consult together for the elimination of double taxation in cases not provided for in the Convention."

The above list is not exhaustive but illustrative.

Sub-paragraphs (a) and (b), besides authorising the competent authorities to agree the attribution and allocation in accordance with the arm's length principle underlying Article 7 (business profits) and Article 9 (associated enterprises), authorises them to reach agreement on a methodology for determining an appropriate transfer price, common treatment of a taxpayer's cost sharing arrangement, or upon an acceptable range of results under that methodology. Sub-paragraph (g) makes it clear that they may also agree to apply this methodology and range of results prospectively to future transactions and time periods pursuant to advance pricing. Sub-paragraphs (c), (d), (e) and (f) the competent authorities may also agree to settle a variety of conflicting applications of the Convention. They may agree to characterise particular items of income in the same way, to characterise entities in a particular way, to apply the same source rules to particular items of income, and to adopt a common meaning of a term. They may agree to the common application, consistent with the objective of avoiding double taxation, of procedural provisions of the internal laws of the Contracting States, including those regarding penalties, fines and interest (*see* Technical Explanation on US Model Convention).

Paragraph 34 of the OECD Commentary on Article 25 gave some illustrations. The competent authorities can—

- complete or clarify where the term has been incompletely or unambiguously defined in the Convention, in order to obviate any difficulty;
- settle any difficulties that may emerge from and arising out of the laws which have been changed (without impairing the balance or affecting the substance of the Convention);
 - determine whether, and if so under what conditions, interest may be treated as dividends under thin capitalisation rules in the country of the borrower and give rise to relief for double taxation in the country of residence of the lender in the same way as for dividends (for example relief under a parent/subsidiary regime when provision for such relief is made in the relevant bilateral convention).

The illustrations indicate that the competent authorities may agree on issues, if necessary to avoid double taxation.

Mutual agreement procedure - Difficulties and doubts - Removing agreements binding

31.5-2 Mutual agreement resolving general difficulties of interpretation or application are binding on administrations (*see* paragraph 36 of the OECD Commentary). The agreement need not conform to the internal law provisions of either Contracting States (*see* paragraph 376 of the Technical Explanation on US Model Convention).

Mutual agreement procedure - Agreements limitations

31.5-3 Paragraph 3 only authorises the competent authorities to reach an agreement to resolve problems, in order to avoid double taxation. Problems of major policy significance are not to be the subject matter of such agreement. These are the subject of negotiations between the Contracting States themselves. The Technical Explanation on US Model Convention clarifies by an illustration, in paragraph 376 :

"For example, this provision (paragraph 3 of Article 25) would not authorise the competent authorities to agree to allow a U.S. foreign tax credit under the treaty for a tax imposed by the other country where that tax is not otherwise a covered tax and is not an identical or substantially similar tax imposed after the date of signature of the treaty. . . ."

Mutual agreement procedure - Double taxation not provided for in the Convention

31.5-4 The second part of paragraph 3 of Article 25 authorises the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention and to resolve any difficulties or doubts arising as to the application of the Convention. They may deal with cases not specifically covered in a treaty. An example is provided by the Technical Explanation on the US Model Convention in paragraph 375 :

"An example of such a case might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third country resident, one in the United States and one in the other Contracting State. Since no resident of a Contracting State is involved in the case, the Convention does not apply, but the competent authorities nevertheless may use the authority of the convention to prevent double taxation."

Mutual agreement - Procedure

31.6 Paragraph 4 prescribes procedure how competent authorities would proceed. They may communicate with each other directly for the purpose of applying the provisions of the agreement, without going through diplomatic channels. In order to reach an agreement, oral exchange of opinion may be necessary or advisable. For that purpose a commission may be constituted, consisting of the representatives of the competent authorities. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in the article. In addition, a competent authority may devise appropriate unilateral procedure etc., to facilitate the above mentioned bilateral actions and the implementation of the mutual agreement procedure.

Paragraphs 38 to 44 of the OECD Commentary on Article 25 contain procedure how the competent authorities proceed to consult together for the resolution of by mutual agreement, either of an individual case coming under the procedure defined in paragraphs 1 and 2 or of general problems relating in particular to the interpretation or application of the convention, and which are referred to in paragraph 3.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - EXCHANGE OF INFORMATION

ARTICLE 26

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is not contrary to the Convention, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultations, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

- (a) *To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State.*
- (b) *To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State.*
- (c) *To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process or information, the disclosure of which would be contrary to public policy (order public).*

IntroductionIntroduction

32.1 The purpose of article 26 is to secure that Contracting States exchange information to ensure the proper application of the terms of the treaty as also of the domestic laws. Other articles which deal with the application of the treaty provisions are 3(2), 24 (Non-discrimination), 25 (Mutual agreement). Avoidance of double taxation and avoidance of tax are the main two objects of a tax treaty. For that purpose, co-operation between the States is necessary. Under article 25, the taxpayer might call on the competent authorities of one Contracting State to consult with the competent authorities of the other with a view to reaching an agreement for the relief of double taxation, when he considers that the actions of one or both the States result for him in taxation which is not in accordance with the provisions of the treaty. Consultation in order to obviate unprovided taxation and also for resolution of difficulty and doubts about the interpretation and application of the treaty provisions for the purpose of eliminating double taxation is thus authorised. The competent authorities could communicate with each other directly for the purpose of such consultation. Under article 26, the competent authorities might need mutual consultation and information about the affairs of the taxpayer necessary for the application of the treaty and the domestic law in relation to him with respect of the covered taxes. Such consultation is necessary not only with regard to the matter relating to transfer pricing but also for the proper assessment of domestic tax generally, including the operation of the domestic provisions against legal avoidance and the prevention and prosecution of evasion and fraud. Mutual assistance is also needed in the collection and recovery of each other's taxes. In fact mutual assistance between the tax authorities seems to be moving out of the sphere of double taxation. Administrative assistance for the ascertainment of the facts in an individual case is of much importance. These are so vastly and sometimes deliberately dispersed that possibility of their ascertainment becomes remote, by a taxing authority of a state in its attempt to prevent evasion. It is because that the tax jurisdiction of a state is confined within its territorial bounds and the tax authority cannot investigate cross border transactions. Taxpayers are able to structure their offshore affairs in such a way that detection by a tax authority of the reality of the situation becomes difficult. It cannot compel information spilling over the territorial jurisdiction of the country, necessary for the true determination of the transactions and their tax consequences. Various steps are sometimes inserted with no economic contents or purpose but only with a view to avoiding tax, between the transactions, which have to be ignored if they are fully investigated. Since they are effected in other countries, the tax authorities are helpless. International co-operation is, therefore, necessary in sharing information. Article 26 provides for it. The aim is not so much to extend the domestic investigative powers, but rather to broaden bilaterally the territorial scope for the application of those powers. Bilateral tax agreements authorise the Contracting States to exchange information as necessary to carry out the provisions of the agreement and to curb tax evasion. The exchange contemplated is on a routine basis. It is specific with regard to a transaction or a taxpayer if a request is made by the Contracting State. The article embodies rules under which information may be exchanged. Paragraph 1 prescribes them. They relate to the subject-matter of the information, its purpose, scope and the extent. The information should be such as is necessary for carrying out the provisions of the agreement or carrying out domestic laws of the Contracting States concerning taxes covered by it as to help, as to assist the Contracting State in combating tax evasion. The exchange of information may include particulars about non-residents also, as such an exchange is not restricted by article 1. The competent authorities may develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made. The emphasis is on preventing tax evasion. Paragraph 2 lays down the obligations of the State in the latter regarding supply of information. The article deals with:

1. Scope of information exchange;
2. Limitation on the information exchange;
3. Structure of the information exchange;

4. Secrecy and uses to which information may be put.

Information exchange - Scope

32.2 The competent authorities of the Contracting States exchange information

- as is necessary for carrying out the provisions of the
- tax agreement, or domestic laws of the Contracting States concerning
- taxes covered by the tax agreement, in particular for
- prevention of fraud or evasion of such taxes

The exchange is not restricted by Article 1.

Information exchange - As is necessary for carrying provisions

32.3 Exchange of information is qualified by the expression "as is necessary". It could be interpreted strictly as to mean that the information may be exchanged only if the relevant purpose could not be achieved without it. Broadly, it may mean that the relevant purpose is facilitated. Strict interpretation cannot be applied as it would narrow the scope of information exchange restricting its effectiveness. The word "necessary" has, therefore, been used in the facilitative sense, as to be foreseeably relevant to the assessment, collection, recovery and enforcement of tax under the domestic law or the tax agreement or for any purpose thereunder. The information is not to be exchanged if its relevance is unlikely *i.e.*, if the relevance is fantastically remote though possible for carrying out the provisions of the tax agreement or of the domestic laws. Likely means probably relevant. The competent authority of the requested state will decide the necessity of information. It will read the necessity in a broader sense, in the manner as discussed. Deep familiarity with the domestic law of other country is not required, nor expected. The authority has to be broadly satisfied about the likely relevance.

Thus, the term "necessary" in the expression "necessary for carrying out the provisions of the domestic laws" may be interpreted as being equivalent to "relevant" and as not requiring a requesting State to demonstrate that it would be disabled from enforcing its laws unless it obtained a particular item of information.

The OECD Commentary on Article 26 provides examples to clarify the principle of paragraph 1 of the Article about the information necessary for the (a) application of the Convention, in paragraph 7, and (b) implementation of domestic laws, in paragraph 8. An instance for (a), information is needed with a view to the proper allocation of profits between associated enterprises in different States or the adjustment of the profits shown in the accounts of permanent establishment in one State and in the accounts of the head office in the other State (Articles 7, 9, 23A and 23B). The instance for (b) it is :— State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B, for information about the prices charged by a company in B, or a group of companies in State B with which the company in State B with which the company in State A has no business contacts in order to enable it to check the prices charged by the company in State A by direct comparison.

The Technical Explanation on the US Model Convention explains in paragraph 365 :

" . . . A company resident in the United States and a company resident in the partner transact business between themselves through a third-country resident company. Neither Contracting State has a treaty with the third State. In order to enforce their internal laws with respect to transactions of their residents with the third-country company (since there is no relevant treaty in force), the Contracting State may exchange information regarding the prices that their residents paid in their transactions with the third-country resident."

Information exchange - Concerned with taxes covered by the tax agreement

32.4 The purpose of exchange of information is to ensure proper application of the provisions of the tax agreement. Carrying out the provisions of the domestic law concerning taxes covered by the agreement, is also its purpose. If the domestic law deals with an area not covered by the agreement, information is not to be exchanged. The application of tax treaties is generally limited to income-tax. Exchange of information in relation to other taxes, for example indirect taxes such as sales tax or custom or excise duties, is not permitted.

However, corresponding Article 26 of the OECD Model Convention was modified in 2000 so as to apply to the exchange of information concerning any tax imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, and to allow the use of the information exchanged for the purposes of the application

of all such taxes. Taxes covered constitute a broader category of taxes than those referred to Article 2 (Taxes covered), all taxes imposed by the Contracting State. Exchange of information with respect to domestic law is authorised insofar as the taxation under those domestic laws is not contrary to the Convention. Under the amended provision, information concerning sales tax may be requested. As regards customs duties, paragraph 11.2 of the OECD Commentary on Article 26 says, "Since the exchange of information concerning the application of customs duties is governed by other international conventions, the provisions of these more specialised conventions will generally prevail and the exchange of information concerning custom duties will not, in practice, be governed by the Article."

Information exchange - Prevention of fraud or evasion of taxes

32.5 The information is exchanged as is necessary for carrying out the provisions of the tax treaty or the domestic laws concerning covered taxes, in particular for the prevention of fraud or evasion of such taxes. The Swiss Federal Court in case of *X v. FTC* [1971] 10 International Legal Materials 1029 interpreted the expression "prevention of fraud" in a case which was concerned with a request for information made by the US authorities under the information exchange article of the US - Switzerland agreement. The court held—

- Prevention of fraud could be interpreted broadly to cover both preventive and suppressive measures;
- It could be interpreted to mean prevention of the ultimate success of the fraudulent acts;
- Whether or not fraud is involved is tested by the law of the country required to supply the information;
- The requested state is not to collaborate in the prosecution of an act which it would not itself punish;
 - The requested state is required to supply the information if the established facts sufficiently warrant a suspicion that fraud has been perpetrated or is planned.

Information exchange - Fraud meaning of

32.5-1 Fraud means a false statement made knowingly or without belief in its truth or recklessly, careless by whether it be true or false (see *Derry v. Peek* [1889] 14 App. Cas. 337). The term "fraud" refers to intentional misrepresentation and may involve :

- manipulation, falsification or alteration of records or documents,
- misappropriation of assets,
- suppression or omission of the effects of the transaction from records or documents,
- recording of transactions without substance.

Fraud may be sought to include properly all acts, omissions and concealment which involve a breach of the legal or equitable duty, trust or confidence, justly reposed, and are injurious to another or by which an undue or unconscientious advantage is taken of another. All surprise, trick, cunning, dissembling and other unfair way that is used to cheat any one are being considered as fraud. But fraud in all cases implies a wilful act on the part of one whereby another is sought to be deprived by illegal or inequitable means of what he is entitled to. In the case of fraud involving revenue, it is the state which must have been sought to be deprived by such illegal means of what is states' revenue. Fraud is dishonesty. A fraudulent misrepresentation is a false statement which when made, the representator did not honestly believe to be true. Defraud involves two elements, namely, deceit and injury to the person deceived.

Information exchange - Evasion (avoidance) of tax

32.6 The shortest definition of tax avoidance is the art of dodging tax without breaking the law. Much legal sophistry and judicial exposition have gone into the attempt to differentiate the concepts of tax evasion and tax avoidance and to discover the invisible line which distinguishes one from the other. Tax avoidance, it seems, is legal; tax evasion, is illegal - *McDowell & Co. Ltd. v. CTO* [1985] [154 ITR 148](#) (SC). Avoidance is a word of wider import than evasion. Ordinarily, there should be nothing objectionable in a transaction lawful in itself, which has the effect of avoiding liability. No liability to tax can arise by reason of merely of abridging or abandoning one's business. But if by reason merely of transaction the business is reduced so as to divert the profits which the person would otherwise have received, and if such transaction is effected with the dominant object of avoiding or reducing the liability, it would be competent for the tax authorities to go behind the transaction and assess the profit which might have been received by the person but for the transaction - *Karumuthu Thiagaraja Chetty & Co. v. CEPT*

[1961] [42 ITR 788](#) (Mad.). The broad guidelines, gathered from various pronouncements of the courts, to determine whether the transaction could be taken attempt at evasion of tax are:—

- Where facts reveal no *bona fide* purpose for the transaction;
- The transaction is legally ineffective or incomplete;
- The transaction is benami or sham;
- Any attempt made retroactively to revise or alter the characterisation of income or other rights and obligations after they have already been created;
- Blatant transactions designed to create the appearance of offsetting the advantages and benefits conferred under the Act. The object and spirit of the allowance or benefit provision is defeated by procedures blatantly adopted to synthesise a loss, a delay or other tax saving devices, though such actions may not attain the height of artificiality;
- The form of law chosen by the parties appears unusual, inappropriate or strange, and in any case unadopted to the economic circumstances;
- Grounds exist for holding that this choice has been improperly made with the sole object of saving taxes which would have been due had the legal relations being arranged in any appropriate manner;
- The procedure chosen would effectively result in notable saving of tax insofar as it is allowed by the taxation authorities. The tax authorities may presume that tax avoidance is intended if the taxpayer chooses to carry out transaction which may be regarded as unusual. Legitimate avoidance occurs when the taxpayer takes advantages of a provision of law, the formulation of which is obscure or incomplete or very complex, so that he can reduce or avoid his liability within the limits of law. If, however, the taxpayer's acting against the will of the Legislature, even if he remains within the literal interpretation of the law, he could be said evading the tax. The revenue authorities may look at the substance of the taxpayer's situation in determining the liability to tax. In a series of transactions with legitimate commercial objective if another transaction is inserted with the sole objective of tax avoidance, that transaction is disregarded for the purposes of taxing on the basis of the end result. This is what is known as "fiscal nullity".

Information Exchange - Not restricted by article 1

32.7 Exchange of information is not restricted by article 1. That article limits the operation of a tax treaty to residents of the Contracting States. Article 26 overrides it. Information can be exchanged in relation to residents and nationals of third countries.

For example, if a third country resident has a permanent establishment in a Contracting State A which engages in transactions with an enterprise of the Contracting State B, the State B could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State.

Information exchange - Limitations

32.8 The obligation under the treaty to exchange information is not absolute. It is subject to certain limitations. Paragraph 2 of the article prescribes them. That paragraph is a sort of proviso and exception to paragraph 1. The treaty partner is not obliged to supply :

- information which is not obtainable under the laws or in the normal course of the administrative practice of the requested or requesting state;
- information which would disclose any trade, business, industrial, commercial or professional secret or trade process;
- information which would be contrary to public policy.

It is also not obliged to carry out measures at variance with the laws or the administrative practice of the requested or the requesting state. The limitations are of two types; those ensuring reciprocity, and those protecting certain classes of information.

Information exchange limitation - Reciprocity

32.8-1 Exchange demands reciprocity. Information is exchanged on the basis of reciprocity. States do not insist on sovereignty while agreeing exchanging information which they are not required to do under the international law even if they so agree, they will not do which the other Government is either unwilling or unable to do for itself.

This is the limitation with regard to exchange of information. The requesting state has to exhaust first its own information collection mechanism. It also cannot take advantage of the treaty partner's investigative powers which it does not have. The state is not obliged to exchange information which is not obtainable under the laws or in the normal course of administration of the requesting state [see article 26(2)(b)]. The information is deemed to be obtainable in the normal course of the administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax administration, which may include special investigations or special examination of the business accounts kept by the taxpayer or other person, provided that the tax authorities would make similar investigations or examination for their own purposes. This means that the requested State has to collect the information in the same way as if its own taxation was involved (see paragraph 16 of the OECD Commentary on Article 26). The requesting state cannot take advantage of the information system of the other state if it is wider than its own. The requested state cannot of course supply information which is not obtainable under its own laws. It is also not obliged to carry out administrative measures at variance with its own, or the other state's laws and administrative practice [see article 26(2)(a)]. The requested state, therefore, is not obliged to exchange information which the requesting state cannot obtain under its domestic laws. Non-obligation does not mean that the state is forbidden to supply information if it so decides. Some of the agreements do not insist upon the requirement of reciprocity. Article 25 of the India-Great Britain (old treaty) agreement limited the exchange to the information which are at the disposal of the Contracting States under their respective taxation laws and obtained in the normal course of administration.

Information exchange limitation - Protected information

32.8-2 The information which would disclose any trade, business, industrial, commercial or professional secret or trade process, would not be disclosed, if the disclosure is contrary to the public policy [see article 26(2)(c)]. Information cannot be withheld on account of the secrecy of trade etc., if the disclosure is not contrary of public policy. In the context of US-Switzerland treaty, the Swiss Federal Court held in *X v. FTC* [1971] 10 International Legal Materials 1029 that "professional secret" covers banker/customer privilege.

What privilege is excluded in the context of the said treaty. It is otherwise not so public policy as the principle of law which holds that no subject can lawfully do that which has a tendency to be injurious to the public, or against the public good. The term "public policy" cannot be defined with any degree of precision. Certain classes of acts are said to be against the public policy on the ground that they have a mischievous tendency so as to be injurious to the interests of the state or the public. It does not admit of any definition. It is equivalent to the policy of law. Whatever tends to injustice of operation, restraint of liberty, commerce, natural or legal rights, whatever tends to the obstruction of justice or to the violation of a statute or whatever against the good morals - when made the object of a contract is against the public policy (see *Kolaparti Venkatareddi v. Kolaparti Peda Venkatachalam* AIR 1964 AP 465). The doctrine of public policy is extended not only to harmful cases but also harmful tendencies [see *Gulabchand Gambhirmal v. Kudilal Govindram* AIR 1959 MP 151 (MP)].

Information Exchange - Structure

32.9 Paragraph 1 of the article provides that the competent authorities shall, through consultations, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchange shall be made. The authorities could thus decide about the structure of information exchange. The commentary to the OECD model contemplates that information may be exchanged :

1. Automatically;
2. On request;
3. Spontaneously; and
4. Other such as simultaneous or tax examinations abroad.

Information exchange - Automatically

32.9-1 Certain information is exchanged without having received any request. It is done automatically at regular intervals. It lacks of taxpayer identification or form. It generally relates to the subject relating to investment income as interest, dividends and royalties. Some information of routine nature may also be exchanged regularly or periodically. It is not a taxpayer specific.

Exchange of information - On request

32.9-2 Specific information with respect of a particular taxpayer may be requested and supplied. Exchange is not automatic. It is subject to limitations as already discussed. The request must identify the taxpayer and specify the required information and also indicate that the taxpayer is subject to treaty partner's laws and that the information is required in good faith after the requesting state having exhausted its own resources. The request commonly relates to ownership of property, control of companies, financial transactions, residency and verification of the filing and reporting of income and expenses.

Information exchange - Spontaneous Information exchange - Spontaneous

32.9-3 A spontaneous exchange does not need a request. A tax investigation may reveal information suggesting non-compliance with the tax laws of the treaty partner. It is supplied without any specific request.

Information exchange - Other than above such as simultaneous or tax examinations abroad Information exchange - Other than above such as simultaneous or tax examinations abroad

32.9-4 The Contracting State may use techniques other than those mentioned above to obtain the information relevant to both the Contracting States, such as :

- (1) *Simultaneous examinations* - It is an arrangement between two or more parties to examine simultaneously each in its own territory, the tax affairs of (a) taxpayers in which they have a common or related interest, with a view to exchanging any relevant information which they so obtain ;
- (2) *Tax examination abroad* - This allows for the possibility to obtain information through the presence of representatives of the competent authority of the requesting Contracting State. This type of assistance is granted on a reciprocal basis ;
- (3) *Industry-wise exchange of information* - It is the exchange of tax information especially concerning a whole economic sector (e.g., the oil or pharmaceutical industry, the banking sector etc.) and not the taxpayers in particular.

Information exchange - Secrecy and use Information exchange - Secrecy and use

32.10 Article 26, *inter alia*, provides that any information received is treated secret in the same manner as information obtained under its domestic laws. If the information is originally regarded as secret in the transmitting state it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved, with respect to taxes covered by the tax treaty, in

- assessment;
- collection;
- enforcement and prosecution;
- appeals.

The information may be used by the tax authorities in connection with the above designated functions. Information received may be disclosed in public court proceedings or in judicial decisions. If the information appears to be of value to the receiving State for other purposes than those referred to above, that State may not use for such other purposes.

The article overrides secrecy obligation. It, however, imposes an obligation on the receiving state to maintain secrecy as it does with respect to the information obtained under its own laws. Thus information exchanged by virtue of article 26 has to be treated secret.

Information exchange - India's approach Information exchange - India's approach

32.11 India favours UN model rather than the OECD model. It enables the competent authorities of the states to develop appropriate conditions, methods and techniques for the exchange of information.

Information exchange - Recent trends Information exchange - Recent trends

32.12 Governments worldwide are coming to realise that the best defence against international tax avoidance and evasion is to expand the mechanism for international co-operation. A border-less world is good for trade and global economic development. It can also provide opportunities for dishonest taxpayers. Exchange of information is the best way to fight tax frauds. Article 26 makes it possible. The Committee on Fiscal Affairs of the OECD has published in April 2000 a report "Improving Access to Bank Information for Tax Purposes"(OECD 2000). The

Report defines the ideal level of access to bank information and identifies measures that would assist countries in moving towards that ideal.

The ideal is :— that all Member countries should permit access to bank information, directly or indirectly, for all tax purposes so that the authorities can fully discharge their revenue raising responsibilities and engage in effective exchange of information with their treaty partners.

The measures are:—

- ◆ eliminate anonymous accounts and require identification of bank customers and beneficial owners of accounts;
- ◆ re-examine what is known as the "domestic tax interest requirement" for exchanging information;
- ◆ re-examine policies and practices that prevent exchange of information of criminal tax cases;
- ◆ take appropriate initiatives to achieve access to bank information for all other tax purposes.

Use of information technology for the effective exchange is now considered as a good measure. OECD countries already have adopted a standard magnetic format. The Working Party of the OECD is also considering how technology can be used to expedite exchange of information, and facilitate procedures for the certification of residence for the purposes of granting treaty benefits.

For assisting tax collection, the Working Party has developed an article for inclusion on collection assistance for inclusion in the OECD Model Tax Convention.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - DIPLOMATIC AGENTS

ARTICLE 27

DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Nothing in this convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

IntroductionIntroduction

33.1 The aim of the article is to protect the fiscal privilege acquired by diplomatic and consular officials under the international law or international special agreement, from the possible adverse effect of any of the provisions of the agreement. These officials are not to receive less favourable treatment than that to which they are entitled to under the international law or under the special agreements.

Diplomatic agents - Privilege and fiscal privilege, meaningDiplomatic agents - Privilege and fiscal privilege, meaning

33.2 The word 'privilege' in its comprehensive sense means an advantage; a peculiar advantage; a peculiar benefit; favour or advantage; a particular and peculiar benefit or advantage enjoyed by a person, or company or class, beyond the common advantage of other citizens; a favour granted; an option—Corpus Juris Secundum, Vol. 72. Privilege can be dispensation of a bounty, a conferment of a personal benefit or advantage, a sanction of immunity or the grant of an exemption. When once a privilege is granted, it ripens into a right—See *P. Bhaskaran v. Addl. Secy. Agricultural (Co-operation) Deptt.* AIR 1988 Ker. 75 (FB).

Fiscal privilege means a fiscal advantage or a benefit enjoyed by a diplomatic or consular official in derogation of common right, beyond the common advantage of other citizens. For example, section 2 of the UN (Privileges and Immunity) Act, 1947 read with section 18, clause (b) of article V of the Schedule thereto, *inter alia*, grants

exemption from taxation to salaries and emoluments paid by the United Nations to its officials. The salary received from the UN is therefore, not to be taken taxable income. Though under the Indian income-tax salary has been defined to include pension, the pension received by the erstwhile employee from the UN is not taxable as salary income in India—*CIT v. Ramaiah* [1980] [126 ITR 638](#) (Kar.) and Circular No. 293, dated 10-2-1981 cited in—*CIT v. Dr. P.L. Narula* [1984] [17 Taxman 223](#) (Delhi). No part of the amount representing benefit to his children from the UN Joint Staff Pensions Fund, is liable to be included in his total income—*Addl. CIT v. R.S. Garg* [1982] [133 ITR 1](#) (Delhi).

Diplomatic agents - Income exemption

33.3 Domestic laws of many countries provide for the retention of fiscal domicile by the residents of a foreign country and so for the exclusion of their income from the taxability net even if income arises both on account of the location of the source and the physical presence of the concerned person in those countries. Under the Indian Income-tax Act, 1961, remuneration received by a person as ambassador, high commissioner, envoy, minister, commissioner, consular or the secretary, adviser or attache of an embassy, high commission, legation or commission of a foreign state, or received by him as *consul de carriere*, or a trade commissioner or any member of the staff of any of these offices is not to be included in the income taxable in India [clause (6) of section 10]. For its own citizens who have been appointed to undertake the jobs of these aforesaid offices and also to do any other services outside India the said Act provides that any allowance or perquisites paid or allowed to them as such outside India by the Government is not to be taken as taxable income [clause (7) of section 10].

By virtue of paragraph 1 of article 4 the diplomatic agents and consular officers of a state accredited to a contracting state could be deemed to the resident of the former state who are liable to taxation therein by virtue of his domicile. The domiciliary status by reason of the place of service does not get changed. For the same reason, this is also true of the international organisation established in a contracting state and their officials if they derive certain fiscal advantage by virtue of their international treaty or agreement.

Thus, the convention or any of its provision does not whittle down any of the fiscal international law or under the provisions of special agreements.

D.P. MITTAL'S COMMENTARY ON INDIAN DTAA s

DOUBLE TAXATION AGREEMENT - RATIFICATION AND TERMINATION

ARTICLE 28

ENTRY INTO FORCE

1. *This convention shall be ratified and the instruments of ratification shall be exchanged at as soon as possible.*
2. *The convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:*

(a) *(In State A) :*

(b) *(In State B) :*

ARTICLE 29

TERMINATION

This convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year In such event, the convention shall cease to have effect:

(a) *(In State A) :*

(b) (In State B) :

TERMINAL CLAUSE

Note : *The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.*

IntroductionIntroduction

34.1 A tax treaty comes into existence upon the declaration of consent of both the contracting states [see Vienna Convention, article 19(1)]. The method by which the contracting states declare their consent is left to contracting parties (see Vienna Convention, article 11). The conclusion of a treaty is generally effected only through an exchange of instruments, or "ratification" [see Vienna Convention, article 14(1)]. The DTA enters into force upon the exchange of instruments or ratification from the date as notified. Article 28 of the model deals with it. Article 29 deals with termination.

Ratification - MeaningRatification - Meaning

34.2 The making of a treaty involves negotiation, signing, ratification and incorporation in the domestic laws of the Contracting State. Ratification is recognised as an international act by which a State establishes on the international plane its consent to be bound by the treaty. Signing merely qualifies the signatory State to proceed with its ratification. Ratification is the formal confirmation by each Contracting State which takes place after it has been signed. If ratification is required, the treaty is not regarded concluded until the instruments of ratification have been exchanged by the signatory States. Article 28 so requires.

Ratification - And Parliamentary consent, distinguishedRatification - And Parliamentary consent, distinguished

34.3 Ratification is to be distinguished from Parliamentary consent. In the document of ratification, the authorised agent (the Central Government in case of India) delivers the formal declaration that the constitutional requirements necessary for implementation for internal application of the treaty have been fulfilled. Upon declaration of the intent to contract through ratification the treaty becomes binding under international law, unless it provides for a different date for entry into force. Such binding force is to be distinguished from its internal applicability. Up to the stage of ratification, Parliamentary consent is not necessary. It is necessary when the treaty having come into force under international law is to be applied internally. It could be done by a special law or by virtue of a provision in the existing law. In India the tax treaty becomes domestically applicable at the time it comes into force, by virtue of section 90 of the Indian Income-tax Act, 1961. Special law is not necessary.

Ratification - And effective dateRatification - And effective date

34.4 Ratification determines the point in time at which treaty enters into force internationally. The domestic law determines the point at which it becomes internally applicable. These are to be distinguished from the point in time at which the material consequences of the treaty begin to take effect, that is the effective date. The effective date is the date from which the taxation shall be limited by the treaty. Usually the initiation of treaty effects is established by explicit treaty rules.

Tax treaty - Coming into force, notificationTax treaty - Coming into force, notification

34.5 Article 28 of the UN Convention Model provides for about when the convention comes into operation and thus has effect in the respective Contracting States. Generally, it is effective, upon the ratification and the exchange of instruments of ratification. As for India, the section which empowers the Central Government to enter into agreement with any other country outside India, *inter alia*, provides that the Government may have to make, by notification in the Official Gazette, the provisions for the implementation of agreement. Such a provision is necessary as it conforms to the process of subordinate legislation in India, especially when the effect of the agreement is to grant relief in respect of income on which has been paid income-tax both under the Indian Income-tax Act and the similar Act of the other country. In the absence of such notification, the agreement cannot be operative in India. The ratification, and the exchange of instruments of ratification, are not sufficient to make the agreement operative, till such ratification is notified in the Official Gazette. The reasons for the notification in the Official Gazette have been discussed in the following paras :

While as observed by Sir C.K. Allen Law and Orders 2nd edn., p. 132 it would seem reasonable that legislation of any kind should not be binding until it has somehow been 'made known' to the public, "that is not the rule of law and if it were, the automatic cogency of a statute which has received the royal assent would be seriously and most inconveniently impaired". The reasoning is that the statutes at least receive publicity of parliamentary debate and that, therefore, they are, or should be 'known'. But this is not true of a delegated legislation, which do not necessarily receive any publicity in Parliament or in any other way. That is the reason for the insistence of the publication of a subordinate legislation in the Official Gazette before it can be brought into force. In so far as the Acts and resolutions passed by the Houses of Parliament and State Legislatures are concerned, the very process of passing the Houses of the Parliament or the State Legislatures gives them ample publicity. The reports of the proceedings of Parliament and the State Legislatures are widely circulated. The newspaper, radio and the television are also the other modern means which give publicity to all Acts and resolutions of the Parliament and the Legislatures of the States—*P. B. Samant v. Union of India* AIR 1988 SC 440.

Where there is a statutory requirement as to the mode or form of publication and they are such that in the circumstances, the court holds it to be mandatory, a failure to comply in those requirements must result in there being no effective order - *State of Maharashtra v. Mayer Hans George* AIR 1965 SC 722. In most of the Indian statutes, there is a provision for the rules made being published in the Official Gazette. It, therefore, stands to reason that publication in the Official Gazette, viz., the Gazette of India is the ordinary method of bringing a rule of subordinate legislation to the notice of persons concerned—*State of Maharashtra v. Mayer Hans George* AIR 1965 SC 722. Also see *CIT v. Shilaben Kanchanlal Rana* [1980] [124 ITR 420](#) (Guj.) and *Girnar Builders (P.) Ltd. v. IAC* [1985] [156 ITR 403](#) (Kar.).

Publication in the Official Gazette means that the Gazette containing the notification is available to the public. Contextually speaking, 'publication' means more than mere communication. To publish means is to make known to the people in general; 'an advising of the public or making known of something to the public for a purpose' (*Black's Legal Dictionary*), 'Publication' is the act of publishing anything, offering it to public notice, or rendering it accessible to public scrutiny, an advising of the public, a making known of something to them for a purpose—*State of M.P. v. Ram Raghubir Prasad Aggarwal* AIR 1979 SC 888.

Mere publication in the Official Gazette does not make the notification effective if such a Gazette is not available to the public. The publication of notification would be complete only when the Gazette containing it is made available to the public—*U.S. Awasthi v. IAC* [1977] [107 ITR 796](#) (All.) and *Kishan Lal v. IAC* [1983] [142 ITR 312](#) (All.). In the *Kishan Lal's* case a registered sale deed in respect of a property was executed on 18-3-1974. A notice under section 269D(1) of the Income-tax Act, 1961 was printed in the Official Gazette dated 21-12-1974. Copies of the said Gazette were, however, made available to the public on 16-1-1975. On these facts, the Division Bench of the Allahabad High Court held, following its earlier decision in *U.S. Awasthi's* case, that the publication of such a notice was complete only when the Gazette containing the notification became available to the public.

Tax treaty - Termination Tax treaty - Termination

34.6 The article containing provision for termination does not contain the period after which or the date on which the agreement will cease to have effect. It is effective for indefinite period until terminated by a Contracting State. The termination cannot, however, be desired before the expiry of some years for which the agreement has been operative, as bilaterally agree upon. The procedure for termination involves the Contracting State giving a notice in writing, through diplomatic channel at least six months before the end of any calendar year. The agreement, therefore, ceases to have effect as regards India, in respect of income assessable for the assessment year commencing on the first day of April in second calendar year in which the notice is given, and subsequent years.
