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TAXATION OF INTERNATIONAL TRANSACTIONS

KEY CONSIDERATIONS

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TAXATION OF INTERNATIONAL TRANSACTIONS
KEY CONSIDERATIONS

1. i. **Nature of international Transaction**:

International transactions are cross border transactions in goods, services, transfer of technology and capital. International taxation is concerned with taxation of such transactions by the home country i.e. country of residence and or by the host country i.e. the source country where the income has accrued. International Taxation is also concerned with defining rights and obligations of non-residents in the host country.

ii. **Parties to International transaction**:

In International Transactions – Two contracting States are involved as the residents of one state carry on a business activity or supply goods and services to the residents of another country or undertake a contract or turnkey project in another state or have agents in the other state to negotiate or conclude orders etc. In everyday life we have ships and aircraft operating in all countries. In the normal exercise of sovereign powers – the Home Country which is the place of residence would tax the resident person on world wide income and the Host country where the income is accrued would also exercise its right to tax such income so generated thus resulting in double or multiple taxation points.

iii. **Prime object of contracting states;**

International Taxation is concerned with the mutual waiver/giving up of sovereign right to tax wholly or partially in the interest of promoting free flow of goods services technology and capital which but for the enactment of DTAA would result in business operations or goods or services becoming

prohibitive – and double taxation would result in minimizing if not neutralizing the benefits of free international trade and cost advantages.

2. **Key Principle of International Taxation:**

In the Home Country or Country of Residence tax is an obligation. In the Host country or source country tax is a cost. When both countries come forward and enter into a treaty to regulate and mutually restrict taxation of such cross border international transactions we see the advent of what is popularly known as a DTAA or Double Taxation Avoidance Agreement. Equally Contracting States are concerned with fiscal evasion and avoidance of No. tax situation which comes about by Treaty Shopping or Treaty Abuse. Hence many of the treaties have a double barrelled object i.e. for avoidance of double taxation and prevention of fiscal evasion.

3. **Key considerations of International Taxation.**

i. Principle of International taxation is ironically not to impose tax but to mitigate and avoid double taxation. This paramount principle is also enacted in Chapter IX of the Indian Income-tax Act 1961 entitled `Double Taxation Relief' which in term states that double taxation relief is to be given `in order to promote mutual economic relations, trade and investment'.

ii. To avoid leakages because of underpricing between group companies or associated enterprises entering into cross border transfer of services, goods etc. by implementing transfer pricing adjustments on the basis of arms length price. These principles are enacted in Chapter X of the Indian Income-tax Act 1961 entitled Special Provisions Relating to Avoidance of Tax.

iii. Just as no man is an island so also no nation can stand alone and isolated. Whether it's the iron curtain or the bamboo curtain the last quarter of the 20th century has witnessed the

systematic ripping off of all such ideological barriers and the establishment of Pro-Capitalist economies from Russia to East Europe to China. Myanmar is probably the last of the `purdas'. Hence there is a considerable increase in joint efforts of countries to enter into Double Tax Conventions to mutually refrain from exercising their plenary rights to tax in recognition of the larger principle of promotion of trade and commerce. There can be no manner of doubt that presence or absence of double or multiple taxation acts as a decisive factor in determining the location of investment and whether or not to establish a business as the taxation factors affects the bottomline of the business.

iv. The principle that is generally implemented is that Tax Revenues are to be shared and allocated between the Treaty Partners. In an era of increasing globalization there is universal acceptance that nations generate wealth not by taxing but by stimulating growth of trade commerce and cross border investments.

4. **Modes of avoiding double taxation:**

Double Taxation is mitigated by three methods

i. **Exemption**

Income arising in source country is to be exempt in the other country, i.e. the country of residence or vice versa.

ii. **Credit method:**

Home country gives credit for tax paid in host country on income arising in the host country. Credit is given at the rate of tax prevailing either in the home country or host country whichever is lower.

iii. **Single point tax:**

Ensuring that there is a single point of tax by designating the place of accrual in specific international transaction such as

international shipping, airlines, captive BPO back office operation etc.

5. **Foundation of Treaty Adherence:**

i. Both contracting states are committed to honour the agreement and to ensure that domestic tax laws do not override treaty provisions. Tax collection has admittedly been foregone to promote and stimulate trade and business transactions with cost benefit weighed against tax sacrificed.

ii. Treaties are binding and must be implemented in good faith as declared in the Vienna Convention on the Law of Treaties – 1969 which is a code by itself. This applies to all nations, especially the principle of good faith, 'Pacta Sunt Servanda ' which has the force of customary international law.

iii. Implementation of Good Faith Principle: The principle is accepted by several countries that provision of treaties prevail over provision of domestic law. The Indian Income-tax Act, 1961 Section 90(2) provides that the DTTA will prevail and further that the provisions of this Act shall apply to the extent that they are more beneficial to the assessee. This means that the assessee has a choice and where the Indian tax provisions are more beneficials they can invoke those provisions as against the DTAA provisions.

iv. The comity of nations has accepted that economic supremacy cannot be achieved unless complexities in interpretation and classification of transactions are addressed expeditiously by amending the Model Conventions or by Appropriate Explanatory notes or Supplementary Agreements or by appointment of High powered committees.

v) In India the CBDT has done exactly that in case of differences and disputes and a high powered committee was appointed to consider the ramifications E-commerce and BPO operations.

There is also a Mutual Agreement procedure (MAP) to resolve disputes – this promotes international understanding.

vi. To provide an effective and efficient method of resolving tax disputes between the non-resident assesses and the tax authorities keeping in view the broad principles underlying Double Tax Avoidance Agreement and by interpreting them liberally and broadly looking to the objects and purpose of the Double Tax Conventions.

vii)The fundamental Rules of Interpretation as embodied in the Vienna Convention of Law of Treaties, 1969 which are at the foundation of every treaty – are is to be honoured by treaty Partners - Article 31.32.33 Questions not regulated by Vienna Convention are governed by rules of customary international law. Accordingly in India the Tribunal, the Courts and the AAR have implemented the following principles:

   i. Treaty must be performed and honoured in good faith Pacta Sunt Sarvanda.

   ii. Treaty language is – paramount – words must receive their usual meaning – intent is as expressed in the text which would extend to any supplementary and subsequent agreements any instrument and subsequent practice and the prepatory notes of the meaning of a term is not clear.

   iii. The principle of non-discrimination should be implemented and a non-resident cannot be in a less favourable position than a resident similarly placed.

6. **History of Model Conventions**:

i) There are four categories of model conventions which have provided the framework for States to enter into treaties. The origin goes back to the post 1st World War trauma when European nations were crippled. The League of Nation was

urged by International Chambers of Commerce to take upon itself the task of reviving , the World Trading System by urging nations to avoid and mitigate double taxation- by structuring the Model Tax Treaties to provide guidelines for reconciling the conflicting claims of sovereign countries with differing tax regimes, ranging from nations with no tax charge, or with low tax, and those with high rates, and yet others with confiscatory tax systems. Thus uniformity was not possible, but object was to provide a pattern of agreement that could be embodied in the Tax Treaties.

ii. **OECD Model:**

Early draft treaties of 1943 – 46 were the starting point then came about the Organisation for Economic Co-operation and Development (OECD) which produced the Model Convention of Income. Capital in 1963 – This was the standard framework used by Nations for constructing bilateral tax treaties. Model Convention was reviewed from time to time in 1974, 1977, 1992 – modified in 2000, 2003 – efforts continue on an ongoing basis to bring about clarity and agreement.

iii. **UN Model Convention**: This was – published in 1980 and reviewed in 2001. The comment of experts is that the earlier OECD model was designed as a framework of agreement between developed countries which gives priority to State of residence over State of Source thus furthering interest of developed countries, as it was in favour of State of residence – source countries where resources are used would stand to lose out. This later UN Model attempted to rectify the imbalance and was mooted by developing countries to encourage flow of investments from developed to developing countries by striking a compromise between the source and residence rule. Emphasis is on the source principle. It gives primary right of

taxation to the host country by employing mechanism to withhold tax on royalty, interest, dividends.

iv. **US Model:** The US Model adopts the OECD Model framework with varieties. It is used by USA for negotiating Treaty. The unique feature of this model is that it contains technical explanation clarifying the various provisions. These technical explantions are an integral part of the treaty and are an aid to intrepretation. The Salient features of the US model are as follows:–

Article 23 provides that P.E. is the basis of tax.

Article 24 provides the 'Limitation of benefits' to residents of one of the two contracting state. Resident entities are entitled to benefits only if they are beneficially owned to the extent of 50% or more by resident individuals of any of the Contracting states which are subject to tax on their world wide income. Such a Treaty therefore does not lend itself to forum shipping.

Article 3 provides that Capital Gains on Immovable properties will be taxable only in the State where the property is situated.

IV Andean Model for South America countries adopts source principles. The variation is that the PE concept is not used – Royalty interest, dividend, income from dividend are taxed in source country.

7. MAIN FEATURES OF DTA MODELS:

i) Defining Extent of right of contracting states to tax. Eg. In the case of shipping or airline business in several treaties the state where there is effective management of the business has right to tax to the entire exclusion of the source country.

ii) Providing for Liability of tax in one country and exemption in another this applies in the case of capital gains arising from sale of immovable property which is

made taxable in the state where the immovable property is located. This income is then exempt in the state of residence.

iii) Granting exemption in one or both countries.

iv) Deeming geographical sources in one, rather than the other.

v) Imposing liability to tax in one country by virtue of deeming provisions.

vi) In respect of business income providing that the taxing right is usually with the home country unless there is a permanent establishment to the host country.

The procedure for application of DTTA's was considered by Andhra Pradesh High Court in

8. 144 ITR 146 – **CIT v. Vishakapattan Port Trust:**

The convention is first applied by the State of source which will decide whether its taxation rights are limited or whether it should tax a domestic source. The State of residence has to decide whether the State of Source has correctly applied the Convention and then grant credit of exemption.

9. **Domestic law vs. DTAA:**

Domestic Law seeks to impose tax in specific circumstances and covers specific heads of Income and Expenses whereas tax treaties specify general principles to avoid double taxation, DTAA's tend to be less precise and call for a broad purposive interpretation and are required to be interpreted liberally and in the context of their object and purpose. Different countries have differing mechanisms for entering into Treaties and for ratifying them.

Section 90(1) of the Act empowers the executive to enter into a tax treaty. The Treaty is not required to be placed before

Parliament. It gets sanction by virtue of sub-section (2) of section 90.

10.**Principles governing interpretation of tax treaties as applied in India**:

i. India has two distinct channels of resolving disputes relating to taxation of international transaction. The traditional method is by the aggrieved party filing appeals against the impugned Order of assessment. The hieracy of Appellate authorities culminates in the Supreme Court of India. The final fact finding authority is the second appellate authority. The Income-tax Tribunal which has benches all over the country is the final fact finding authority against whose Orders appeals can be filed by the assessee or the revenue to the High Court or the Supreme Court only on questions of law. The Tribunal Benches have decided a vast number of such disputes relating to cross border transactions applying the relevant provisions of domestic law and DTAA and reconciling such conflicts.

Recently there was a press announcement that the ITAT will constitute Special Benches for hearing such disputes expeditiously and efficiently as it was conscious that it was the cynosure of international bodies dealing with international tax issues.

The second channel available to non-resident undertaking or proposing to undertake a transaction in India is to apply to the Authority for Advance Ruling for a determination on questions of law or fact relating to any computation of income. This application can also be made by the resident who has the business dealings with the non-resident. The Appellate Authorities and Authority for Advance Ruling have in numerous cases applied these principles and arrived at a fair

and equitable ruling in consonance with the key principles of International taxation.

The landmark case is that of Azadi Bachao Andolan 263 ITR 206 (SC). Another important case is that of Boston Consulting Group P.Ltd. – 280 ITR at 1. There are of a host of others.

ii. **Principles culled from these judicial pronouncements** :

i. A tax treaty is not a taxing statute.

ii. It is an agreement regarding mode of computing taxes regarding international transactions which over-rides the domestic tax legislation.

iii. Tax treaty is to be interpreted on the good faith principle in the light of the Universal object of Avoidance of Double Taxation.

iv. Words of the Treaty are not to be examined in precise grammatical or literal sense.

v. Tax Treaty requires to be interpreted harmoniously and read as a whole. Thus departure from plain meaning of words is permissible whenever context so requires to avoid absurdities.

vi. There should be no discrimination against the non-resident assesses as compared to resident assessee.

vii. The Treaty should be made workable rather than redundant.

viii. India has entered into Double Taxation Agreements and Conventions with more than 70 countries – the Countries that have not entered into DTA's are Hongkong, Luxembourg, Channel Island. However even in case of no treaties Sec. 91 of the Income-tax Act provides that deduction can be obtained by a resident with respect to the income accured abroad and taxed abroad subject to proof being furnished.

11. **Permanent Establishment:**

The concept of Permanent Establishment of pivotal for taxation business profits of a non-resident corporation or enterprise. Usually unless the non-resident has a permanent establishment according to various tax treaties, the profit is not taxable in the source country.

Permanent establishment would be constituted by a fixed place of business i.e. branch office, factory, workshop, sales outlet, warehouse, ownership of oil walls, and by appointing agents who are not independent..

PE under some DTAA such a Indo-UK.

Excludes

Facilities used only for storage, or display of goods, collecting information, for advertising or for scientific research which is only incidental to the main trade or business.

PE however includes

Installation of structure used for exploration or exploitation of natural resources.

Where managerial services are rendered for more than the minimum period – 90 days as is the case of Indo UK.

Royalties and FTS are taxed at source irrespective of the number of days of stay.

12. **Important issues arising from Cross Border Transaction:**

There is a constant debate about characterizing and distinguishing Royalties, and Fees for technical services, on the one hand and, business profits on the other.

i. In the case of Hewlett Packard CP Ltd. v. ITO 5 SOT 660 (Bang) 2002 the facts were as follows:

HP had provided networking solutions to clients along with software packages. Assessing Officer held that the entire

payment was royalty payment and liable to TDS. Assessing Officer denied the deduction as no TDS was deducted thus invoking the disabling provision of section.

Held by ITAT that royalty is payment for use of copy-right of product. In this case this was not just a grant of license for use of copy-right. Held that payment constituted business profits – However since seller had no PE hence business income not taxable. No liability to deduct tax. Hence payment was deductible in the hands of the resident payer.

ii. On the other hand in the case of Satellite Television Asian Region v. DCIT – 99 ITD 99 (Mum).

Sale of airtime by non-resident Company to channel Companies who were also Non-Residents was held to constitute sale taxable in India because the situs of sale, delivery and purchase was in India. Assessee was therefore enjoined to deduct tax at source under section 195. Since tax was not deducted hence expense disallowed by virtue of section 40(a)(1), which provides that failure to deduct tax at source in the case of a Non-Resident receiving payment would disentitle the expense from being deducted. This was a case of a Company resident in Hongkong and since there is no treaty between Indian and Hongkong the subscription fees were brought to tax because of the business connection.

iii. However in a very recent case of Pan Am Sat which was a resident of USA the Delhi Bench of the Income Tax Tribunal has held applying the India USA Treaty that in the absence of a PE the fees paid by Indian broadcasting Companies such a Doordarshan BBC Sony to Pam Am Sat would not be subject to tax and hence no TDS was deductible, and

further amount of payment was deductible as a cost not to be disallowed under section 40(a)(1).

iv. In re: Rotean Company and Mitsubishi Corporation – 279 ITR 165 Facts situation encompassed the India Korea DTA and India Japan DTA. Facts as follows:

Consortium of foreign companies entered into a contract with Delhi Metro Rail Corporation (DMRC) for a turnkey job which included design, manufacturing and commissioning of passanger rolling stock.

Fixed lump sum consideration provided under the contract.

Held by Authority for Advance Rulings:

(a) In a composite contract services will be inextricably linked with manufacture and supply,

(b) Only where service element is severable that a portion of consideration will be assessable as FTS (Fees for Technical Services).

(c) Activities of Design and Manufacture include coordinating with other contractors and engineers.

Held by AAR that such services did not involve any element of Technical Services. However other independent services not connected to manufacture such as training of Driving Instructors and Supervisors and Maintenance Services could be regarded of FTS within Article 13 of DTAA between India- Korea and held that under Article 12 of DTAA between India-Japan. Proportionate part to be treated as FTS.

In the case of Sundwiger EMFG & Co. and others 262 ITR 110 (Andhra Pradesh H.C.) the facts were that Indian Company placed orders with Non-Resident Companies for supply of capital equipment such as cutting and polishing machines for metal projects. The main contract was in two

parts. The preamble stipulated that supplier would undertake design, manufacture, inspection, sale delivery. Part I spelt out the technical specifications. Part II dealt with financial levies. There was a separate contract for technical services covering supervision of erection, commissioning of the equipment. The contract provided that the specialists who were under the employment of the Non-Resident would come to India on deputation.

The Indian Company had to bear the expenses and charges for employees daily charges, travel, living, and out of pocket expenses. The contract further stipulated that the employee would take on the burden of all taxes and duties without deducting any tax from the amount fixed under the contract. When the Indian Company applied for clearance certificate for setting the remittances for the agreed fees, the AO held that they were taxable under section 9(1)(vii) of the Income-tax Act as `Fees For Technical Services'. The High Court analysed the contracts and came to the conclusion that this was a contract between Principal and Principal and that the two contracts read cumulatively clearly showed that they were inextricably connected to supply and commissioning of equipment and that merely because it was a separate control the services for starting and commissioning the equipment did not amount to a business connection as the services were incidental to the main contract of sale and supply of equipment. Since there was no PE hence no income accrued in India under the charging section 5(2). It was further held that even though there was a separate contract for provision of services however since services were ancillary to the main contract which was for supply hence fees paid were taxable as business income.

vi. In the case of Horizontal Drilling 237 ITR 142 AAR – the assessee had a PE for rendering services in the course of its business which comprised design engineering and installation of underground pipelines through Permanent Establishment. It was held that fees were taxable as business income.

13. **Determination of profits attributable to PE:**

The relevant provisions of the Domestic Tax Law and the DTAA or Treaty when read in conjunction determine whether the profits are attributable to the PE. And if there is no PE how is to be taxed.

Under clause (1) of Section 9 of the Indian Income-tax Act 1961 only that business income which accrues or arises through or from any business connection in India, is deemed to accrue or arise in Indian and is taxable in the hands of non-residents. The concept of `business connection' in the domestic law of India is akin to the concept of P.E. in tax treaties. The existence of PE is an indication of a concrete business presence in the source state of the residents of the other States enabling them to carry on operations regulating in business profit. Without a PE as defined under the DTAA the business income does not become taxable in India. For instance an international transaction involving direct orders placed abroad and goods supplied in response without any local activity does not give rise to taxable income. If there is a PE giving mix to business profits then the quantum of profits attributable to the PE are to be determined this concept is known as the Force of Attraction Rule.

14. **Shipping & Airline Profits:**

One of the key consideration of DTAA is to have an agreed definition of commercial and business terms such as International Traffic and Shipping Profits. E.g. Shipping profits has an extended meaning which includes profits from incidental activities such as:

- what is included in the business
- Sale of ticket for other enterprises.
- Lease of ships
- Use maintenance and rental of containers.
- Interest on funds connected with shipping operations.
- Other activities directly connected with shipping operations.
- Capital Gains on disposal of ship or other connected movable assets.
- Profits from pool joint business and international operating agency.
- Operation of bus service connecting town with airport.
- Advertising and commercial propoganda.
- Providing services to other transport enterprises in a foreign country for the purpose of operating its ship or aircraft.
- Maintaining hotel exclusively for transit passangers at cost of which is included in the ticket.

Article 8 of Treaties covers Shipping & Airline Profits. Treaty provisions are honoured over the domestic Taxing Statutes.

ii. As far as ships or aircraft engaged in international traffic are concerned, Article 8 provides that profits would be taxed where the effective place of Management of Enterprise is located. This is a departure from the PE principle. Thus all profits from these extended activities will be taxed at one point, i.e. where the effective management is located and

exercised. This is because of the feature of this business is that it is carried on on high seas or airspace and the ship or aircraft which is on the move. If the PE principle was adopted each country would tax a portion of the profit attributable to the PE in each respective country. Thus there would be multiple points of taxation. Treaty provisions where they are applicable are honoured over the domestic law provisions.

iii. Effective Management means where the Management decisions and directives are actually implemented and carried out.

In the case of Universal Cargo Carriers – 205 ITR 215 (Cal)- Shipping Company was registered in Panama – Ship Management Agreement with Greek Company which gave wide and sweeping powers to the Company, held place of effective management was Greece where day to day affairs were managed and controlled and not where ultimate control resides. Hence the court applied the DTAA between India and Greece and the set of residence under Article II(1)(f) of the DTAA which stipulated that a Company is regarded as being resident in Greece if its business is wholly managed and controlled in Greece. Despite the fact that the Panama Company the owners of the ship had vestiges of ultimate control because they had the right to secure accounts however when contrasted with the powers exercised by the Greek Company such as to appoint and dismiss the staff, to control entire shipping business, to collect and disburse moneys to negotiate contracts etc. The fact that the Greek Company was entitled only to a commission at a certain percentage of the total freight collection did not militate against the conclusion that it did

exercise control over the business and it did manage the business. The High Court also drew support from the definition of the term resident in section 6(2) and 6(3)(i) where the expression 'control and management' is used in relation to affairs.

The High Court held that assessee was entitled to 50% relief from tax under Article III of the DTAA between India and Greece.

The some principle was upheld in Container Feeder Services 96 ITD 377 with vastly different results.

The Company was incorporated in Mauritius and engaged in shipping business. However the Company sought to rely upon Article 8 of the India Mauritius DTAA on the basis of a certificate of the Mauritius Authorities certifying that Mauritius was the place of effective management. The I.T. authorities made enquiries and came to the conclusion that the Shipping activity was defacto controlled and managed from Dubai - only Board Meetings and paperwork correspondence was in Mauritius. Management such as broking of orders, appointment to engineers and other operations took place in Dubai. It was held that Dubai was the place of effective Management, not Mauritius. ITAT did not admit tax residency certificate of Mauritius. ITAT applied section 44B of the Indian Income-tax Act to compute the tax liabilities on a presumptive basis.

Section 44B applies to Non-Resident who carry on business of shipping in India on a regular basis.

Profits from Pool Arrangement

Case of Lufthansa German Airlines vs. CIT 90 ITD 310 Delhi. Held such activities covered under Article 8 and not

Article 7 and not taxable in India but where the effective management is located.

James Mackintosh & Co. Pvt. Ltd. 92 TTJ 388 (Mumbai)

India – Netherlands DTAA

Article 8 provides that income from international traffic taxable in the country of residence of the assessee.

Article 8A(2) provides that in case the income is derived from shipping activities which are more than casual in the other contracting state then the other contracting state could also tax that income. Company was engaged in tramp shipping.

On facts it was found that the Company ships sailed seven times through India – Held it was more than casual. This finding could not be negatived by the fact that section 172 of the Income-tax Act which applies to occasional shipping business (as opposed to section 44B which applies to regular shipping business) was applied for computation of tax.

15. **Royalty-FTS – Computer Software – E-Commerce:**

i. In all international transactions there is an interplay of tax laws of the source country, home country and the provisions of DTAA.

Section 90(2) provides that the assessee can opt either to be taxed under the Act or the Treaty whichever is more beneficial (Circular No.333 dated April 2, 1982) UOI v. Azadi Bachao Andolan 263 ITR 706 (SC).

Royalty Agreement.

Agreements entered into after 1st June 2005 have a favourable tax rate of 10+2.5 for companies which come within section 115A. prior to this amendment assessee

would opt to be taxed under the treaty which provided for a lowest rate as the Indian rate was 20%.

If Royalty/FTS connected with PE/fixed place - normal rate 40% of net basis applicable to foreign Companies.

If Agreement approved by Government it is taxable on gross basis on the basis of 10%

Article 7 - provides that if royalty FTS attributable to PE then it is taxable as business income and Article 12 would not apply even though it is royalty dividends or interests.

ii. Royalties shall be deemed to arise in the contracting state where the payer is resident. However whether or not the payer is resident of the contracting state if the payer has a PE or a fixed base in connection with which royalties were incurred then royalties shall be deemed to arise in the State. Same rule applies to India cl.(vi)&(vii) of section 9(1) provide for deeming accrual rule for income from royalty and FTS.

If Royalty/FTS payable by Government accrual in India.

Royalty/FTS by Resident acrrual in India.

iii. Exception: If Services utilized for business or profession carried on outside India or for earning income from a source outside India.

CIT v. Aktiengesellchaft Kunnle Kopp and Kause 262 ITR 513 (Mad) Royalty fees paid by resident in India out of export sales hence source of royalty fees was outside India.

In the case Wallace Pharmaceutical Pvt. Ltd. 278 ITR 97 (AAR).

Indica Company engaged in production of pharmaceuticals entered into a consultancy Agreement with US Company for research advice. One of the aspects was to advice on marketing and production and the US Companies and to bring about tie ups with foreign Companies.

Held commission payable was not for business or profession carried on outside India or for earning income outside India but for earning income in India. Hence the Consultancy fee was deemed income of foreign Company in India.

Similar test was applied in South West Mining Ltd. 278 ITR 233 AAR.

The Consultant carried out lab test outside India and prepared tests outside India. However the results and reports were utilized in India. Hence commission was held taxable in India.

The ITAT annalysed of the taxability of FTS in the case of Lufthansa Cargo India (P) Ltd. 91 ITD 133 (Del) v. DCIT.

Sources from which assessee earned income were outside India and hence excluded under clause 9(1)(vii)b.

Not relevant

Relevant

Status of assessee Where services are utilized

Place of contract

Place where services are rendered

Place where payment is made

This Rule applied in Steffen Robertren Kirsten Consulting Enterprises 230 ITR 206 AAR

Elkan Tech v. CIT 250 ITR 164 (AO)

Raymond Ltd. v. CIT 80 TTJ 120 (Mum)

iv. Royalty and FTS paid by one Non-Resident to another Non-Resident is taxable in India only if payer has PE in India and the royalty is paid for a right property or contract connected with PE.

Terms FTS and FIS (fees for included Services) are defined in a narrow and restricted sense under the India-

US, India and India UK Singapore Treaties Article 12(4)(b) of Indo-US Treaty speaks of rendering of technical or consultancy services which make available technical knowledge, experience, skill, knowhow or process.

MOU to the Indo US tax Treaty that technology is said to have been made available when the recipient of services is enabled with the knowledge to apply the technology the key words are technical services not just use of standard facilities. Technical services would be construed to be in the realm of applied and industrial science. Hence in the case of Skycell Comm. Ltd. v. CIT 251 ITR 53 (Mad) it was held that mere collection of a fee for use of a standard facility falls short of norm of technical services.

Similarly in the case of Wipro Ltd. v. CIT 80 TTJ 191 (Bang) Held payments made by Wipro to service producers for down linking services not taxable in India.

The ground for coming to this conclusion was that no technology was made available or provided while rendering down linking services. The argument of Revenue that the annexures to the contract contained detailed operating procedure and therefore amounted to providing technical services was negatived on the reasoning that mere deploying of sophisticated equipment by service providers did not amount to making available technical services.

This principle was followed in the case of Software Technology Part (3 SOT 529 (Bang).

Facts

STPI paid compensation to US Companies for internet services to facilitate end to end communication facilities.

Held payment not covered under section 9(1)(vii) hence not taxable as FTS.

In the case of Mckinsey & Co. Inc. 99 ITD 549 (Mum) US Co. provided geographical data and information to Indian Br. Office. Mckinsey India was earning fees from rendering strategic consultancy services to clients in India. Payments made to Mckinsey USA by the Indian Branch were held not to be fees for included services and hence not taxable in India. Further these services were held to be of a non technical nature held not taxable under Article 12(4) of the Treaty as there was no technology to be applied.

v. In the case of DCIT v. Boston Consultancy –

Held that services in the area of marketing and sales business strategy rendered by the Singapore based Company through a PE in India did not amount to technical services under the relevant Article 12(4)(b) of the India Singapore Tax Treaty. The Income Tax Tribunal held that once the assessee chooses to be covered by the Provisions of an applicable tax treaty, it is not open to the Revenue to thrust the Provision of the Income Tax Act on the assessee.

Question whether payment made for purchase of drawings and designs comes within the definition of royalty. In several cases it has been held that outright purchase price paid for acquiring products did not come within the definition of the term royalty. However, in the case of Leonhardt Andra Und Partner, GMBH v. CIT (2001) 249 ITR 418 (Cal) it was held that payments received for supply of drawing and designs for bridge construction held to be royalty under section 9(1)(vi).

In the case of Indian Hotels Co. Ltd. facts were that Foreign Company had to provide and handover all plans for Interior

design these plans were not for any other extraneous purpose. Held that under Indo Singapore Treaty they were neither royalty nor FTS as there is a limited non-exclusive use of drawings and designs which were to become the property of the assessee. Hence there was no withholding of tax required.

16. Endeavour of OECD & Other Organisations:

i. One of the tasks of organizations such as OECD is to iron out ambiguities of terminology as well as clarify the implications of new age commercial concepts. One such area in which there has been considerable debate is in the case of acquisition of computer software. The issue to be decided is when the computer software is acquired, whether the payment is made for use of copy right or whether the payment is for a copy righted article? The payment can be termed as Royalty Payment if it is a transferable right in the copy right of the computer programme. This is for grant of use of the copy right. This would include making copies of the programmes or making derivative computer programmes or publicly displaying the computer programme.

ii. The second category is FTS i.e. Fees for Technical Services. This would be a case where service is rendered for further development or modification or variation of a computer programme. The nature of the acquisition is to be gathered from the intent of the parties and by determining which party is the owner of the copy right and which party would bear the risk of loss. In the case of a service provider, who is merely working on the development of the programme, there is no transfer of any rights and hence if it is only a case of rendering service, the payment made would be classified as FTS.

iii. The third category is purchase of product. Here the customer acquires the standard computer programme which is already copy righted. The copy of the programme may be either in a floppy or in the hard drive or in the medium or it would be a outright purchase of the product. This issue was considered in the case of Samsung Electronics Co. Ltd. 276 ITR 80 (Bangalore). In this case the Bangalore Tribunal held that payments made by an Indian Company to a foreign Company which exported the software to the Indian Company was not 'royalty' as the copy right remained with the American Company and what the Indian Company acquired was a standard product copy. The principle laid down by the Supreme Court in the case of Tata Consultancy Services vs. State of Andhra Pradesh 271 ITR 401 was applied wherein the Supreme Court held that when software is put on a tangible medium, it would be classified as goods. This decision has been followed in host of other cases wherein it has been confirmed that shrink wrap software, which is imported would amount to purchase of goods and hence payment is not royalty. The conclusion therefore is that in such cases there will not be any withholding tax on the payment. The taxability of the amounts paid would depend upon whether the foreign Company has PE in India.

iv. This principle is once again confirmed in the case of Motorola, Ericson Radio System AB and Nokia Corpn. 96 TTJ 1 (Del) (SC). Here again it has been held that payment made for transfer of non-exclusive restricted license could not be classified as royalty even though the Agreement referred to a grant of licence. The Tribunal analysed that under the Copy Right Act grant of use of copy right is an

exclusive right and since in this case there is a non-exclusive right, which was given to the user for their own purpose, and maintenance of the product and not to exploit it commercially and hence such right did not fall under any other clause of the Copy Right Act. What the assessee acquired was a copy righted article, hence, since the gain resulting was not a commercial gain in the absence of a business connection, profits accruing to a foreign party cannot be brought to tax in India.

v. Some interesting issues also arise in e-commerce transactions. In such cases typically an online Company might be located in India, the website may be controlled from Singapore, the server leased by the Company may be located in the Virgin Islands, the buyers may be in all jurisdictions accessing the website and placing orders for the items listed. The online Company has several revenue streams such as sale price, leasing fees, charge to a seller, advertisement revenue etc. to examine all these ramifications, the OECD set up a Technical Advisory Group (TAG) and also Central Board of Direct Taxes (CBDT) constituted a Highly High Powered Committee (HPC) to give a report on these characterization issues.

vi. Another current issue was the purchase of Business Information Report (BIR). This has been analysed in two reported cases by the AAR.

a) Dun and Bradstreet Espana SA (2005) 272 ITR 99 (AAR)
b) BBC Ltd. (2006) 201 CTR 227 (AAR)

The AAR negated the department's contention that payment for such BIRs ought be classified as royalty payment and FTS under the Treaty. It was held that the BIR is a standard product providing information which is in the

public domain and that the sale of a BIR is like sale of a book, the consideration that has paid is not for use of any right in the copy right etc. This principle was amplified in the case of HEG Ltd. 263 ITR 230 (MP) in which it was held that to classify a payment as royalty, there must be some expertise and skill that has been transferred along with the information. In another case of Essar Oil the Tribunal held that fees paid for supply of Credit Rating Certificate was payment for commercial information was taxable as royalty under the Indo-Australia Treaty and further because S&P had undertaken the task of processing information received from the assessee by conducting research in a scientific manner. This was also because of the Indo-Australia Treaty specifically classified payment made for supply of industrial or commercial knowledge or information as royalty.

17. New Age Business Transactions:

i. In the area such as E-commerce, and BPO operations a large number of controversies have arisen because these are non-traditional modes of doing business and the traditional tax laws did not envisage such revolutionary developments. Thus one of the key considerations of the International Bodies that are concerned with international taxation is to categorise such transaction, recommend changes in the Treaty language, carry out amendments etc. so as to subserve the need of countries to promote the free flow of goods and services without the barriers of double taxation or multi-point taxation or inequitable taxation.

ii. We are now living in a truly interdependent world where outsourcing by developed nations to economically less developed nations seems to be the key to the sustaining the financial success of mega corporations. Hence BPOs, LPOs

and KPOs have mushroomed in Asia much to the consternation of employees who have lost their jobs because of price arbitrage. The ultimate irony was the outsourcing of funeral services in UK being performed by Indian priests who performed the last rites in a disembodied voice over the internet!

iii. Outsourced activities such as call centers accounting procedures, medical transcription services, Architectural design services and Research services have posed a new challenge in the are of International Taxation. The Central Board of Direct Taxes has issued Circular No.5 of 2004 addressing these problematic situations. This is in keeping with the norms and principles of International Taxation that ambiguities should be addressed at the executive level so as not to impede trade and commerce. Once again the test of PE has to be applied as per the relevant DTAA.

In several cases the foreign Company have set up subsidiaries and joint venture Companies or even branches. It is now clear that even where the BPO unit is held to signify a business connection in India if it is a cost saving BPO as distinguished from a customer facilitating BPO, the former do not produce or generate income and merely save an administrative expenses as compared to other BPOs which carry out higher end services as part of the income earning process like computer aided designs, accounting services, and legal research and documentation research on actual cases would come within the income earning category. Even if the BPO constitutes a PE of the parent Company and even if there is a business connection established if the BPO is engaged in preparatory and

ancillary activities then e.g. under the UK-India Tax Treaty it is excluded from the definition of PE.

iv. In a ruling in the case of UAE Exchange Centre LLC (268 ITR 9) the AAR examined the activities and held that one of the activities of the liaison office namely of attending to customer complaints was in the nature of preparatory and auxiliary activity but the other activity of actually downloading customer related data, printing and delivering cheques to customer constituted the mainstream of the work and in that respect constituted a PE in India.

18. EPC Contracts:

i. The area of EPC contracts (Engineering, Procuring and construction) is again loaded with complexities. The taxability with regard to EPC contract would depend on the contract structure (single contract or split) and whether the supply of equipment is on shore or off shore and further whether the Non-Resident contractor has a business connection in the contracting state, and whether it operates as a consortium. For example, the Non-Resident contractor, who supplies equipment off shore under a contract concluded abroad but has a business connection in India, the question is whether the payment made to such contractor is subject to tax in India. Section 9 of the Income-tax Act has Explanation 1A which clearly states that only such portion of the income can be taxable in India which is attributable to the operations carried by the Non-Resident in India. Some Tax Treaties have also embodied these "Force Of Attraction" Rule such as Indo-US and Indo-Japan Treaty. This rule will apply for example when the negotiations for supply of equipment were held in India but the supply is outside India. This would be probably

sufficient to establish a business connection under section 9(1) of the Act. The Indian Income-tax Act Rule 10 gives comprehensive powers to the Income-tax authorities to apportion the profits to the Indian business connection.

ii. In the case of Ingrsol Rand Ltd. vs. ITO 4 ITD 654 the ITAT applied the rules and taxed 10% of the total profit because the assessee had an agent in India who had negotiated and engaged in various activities on behalf of the principle.

iii. In the case of Indo-Japan Tax Treaty this 'Force of Attraction Rule' as it is called is amplified in the Exchange of Notes between India and Japan wherein it has been explained that the profit of the enterprise would be taxed in the contracting state to the extent that such profits are directly or indirectly attributable to that permanent establishment. The notes go on to expound that it is only that profit arising in transactions in which the permanent establishment has been involved would be regarded as being attributable to the PE to the extent appropriate to the part played by the permanent establishments in those transactions made and it further goes to clarify that even when the order for purchase of goods is placed directly with the overseas head office rather than with the permanent establishment even in such a situation profits would be regarded as attributable to the permanent establishment. This is a case of DTAA preempting the by-passing of a PE in commercial transaction to avoid taxation.

iv. An EPC contract may also give rise to a variety of PEs which are provided for in the OECD Article.

a) Equipment PE - where there is leasing of equipment by the contractor to the owner. If it is a dry lease, then there is no establishment of the Equipment PE. This

comes into existence only when there is a wet lease. This is when the contractor's personnel stay in India for more than the threshold number of days stipulated in the DTAA.

b) The Construction PE - which comes into being when there is construction site or installed project. The period giving rise to constriction PE is 12 months under the OECD Model. However different treaties have adopted different period, for example the Indo Singapore Tax Treaty provides that a construction PE would be established if the number of days in any fixed year exceeds 183 days. This period should fall within one financial year and not in overlapping financial years. The Courts and Authorities have held that without these being a PE in India as per the relevant DTAA no part of the profits can be charged under the Indian Income-tax Act even though such activities were carried out on Indian territory and the profits in the normal course would have been charged to Indian Income-tax but for the relevant DTAA. This is based in the settled principle that specific provisions of the DTAA should override the general provisions of the Income-tax Act unless the statutory provision is more beneficial to the assessee.

c) Service PE - In this case if the services rendered in the host country is exceeding the threshold period, then the service PE is said to have been established. In the case of Bechtel 228 ITR 487, the AAR considered the activities of the French Company Bechtel which had been contracted for completing a turnkey project encompassing transfer of technology providing of

equipment, commissioning of plant. Under the contract Bechtel was also paid a consideration for use of patent trademarks modules etc. which were owned by Bechtel and for supply of information of industrial or commercial nature and also fees were paid for services of management, technical, and consultancy nature. Bechtel had a base in India for the activity of installation of plant and it was held that Bechtel had a PE hence all the services that has been imparted with were effectively connected with the PE and hence would be covered by Article 7 of the Tax Treaty. However, since the terminology of the Article 7 referred to the profits being attributable to the activities carried out by the PE in India, it was held that the activities and services rendered outside India, though effectively connected with the PE were not attributable to the PE and hence not taxable. It was held that the word 'attributable' is of a much narrow import than effective connection with the PE.

v. In relation to EPC contracts, the aspect of hiring out of labour has given rise to considerable scope for tax planning under the OECD model. To take advantage of this short stay exemption, the employee are stationed in the host country for less than 183 days in any fiscal year and the remuneration is ;paid by a Non-Resident which is not borne by any PE which the employer may have in the host country. In this case it was found that the employment was done through an intermediary Company by adopting a device known as "international hiring of labour". The intermediary is established abroad and is the ostensible employer which hires labour out to the actual employer for

less than the stipulated time period. This is one instance where the OECD Model commentary has cautioned nations about the Treaty abuse and has prescribed that substance should prevail over form and to determine who actually is the employer, by applying the test as to who has the right on the work produced and who bears the responsibility and risk.

vi. Some contracts are complex by their very nature because of splitting up of contracts and because of Consortiums being involved. Genuine difficulties arise in the case of tripartite involvement where three countries are involved for example UK resident which in India undertakes an EPC contract. The PE make some FTS payments to a US resident for certain activities carried out in India. In this scenario, the US Resident might suffer double withholding tax on the FTS payment received by it, one under the Indo-UK tax Treaty and the second under the US-UK Tax Treaty since the payment was made by the Indian PE in connection with the activities in India and borne by the PE in India. In such a case special provision has to be made, to avoid double withholding tax by two countries. There are tax efficient jurisdiction which provide for higher threshold of stay. E.g. under the Tax Treaty with Singapore, Malaysia. These are used as base jurisdiction for setting up entities for structure of leasing equipment etc. Mauritius, Cyprus, Japan which do not have a service PE clause. These Treaties are thus invoked by using these countries for basing the Companies rendering these services.

19. Treaty Shopping:

The question that arises is whether assesses can legally resort to Treaty shopping or tax avoidance and to what

extent. A negative ruling was given and the AAR has held in the case of Natwest that if the sole objective of the UK Company setting up base in Mauritius was avoidance of tax by exploiting language of Indo-Mauritius Tax Treaty then such an application cannot be entertained for rendering an Advance Ruling as it is prima facie a case of tax avoidance. In 224 ITR 473 however the Supreme Court has taken the very broad view of this issue in the landmark case of Azadi Bachao Andolan as follows:

"..... if it was intended that a national of a third State should be precluded from the benefits of the Double Taxation Avoidance Convention, then a suitable term of limitation to that effect should have been incorporated therein .... The appellants rightly contend that in the absence of a limitation clause, such as the one contained in Article 24 of the Indo-US Treaty, there are no disabling or disentitling conditions under the Indo-Mauritius Treaty prohibiting the resident of a third nation from deriving benefits thereunder. They also urge that motives with which the residents have been incorporated in Mauritius are wholly irrelevant and cannot in any way affect the legality of the transaction. They urge that there is nothing like equity in a fiscal statute. Either the statute applies proprio vigore or it does not. There is no question of applying a fiscal statute by intendment, if the expressed words do not apply............

.... There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development. Deficit financing, for example, is one; treaty shopping in our view is another. 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. Whether it should continue, and if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political consideration. This court cannot judge the legality of treaty shopping merely because one section of thought considers improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy..........”

The Supreme Court in this landmark judgement with its exhaustive and comprehensive analysis has delivered quite the last word on the subject of Taxation of International Transactions and Treaty Adherence.

1/taxation